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NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 700 and 702

Prompt Corrective Action; Risk-Based Net Worth Requirement

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final Rule.

SUMMARY: In 1998, the Federal Credit Union Act was amended to require NCUA to adopt a system of prompt corrective action for federally-insured credit unions. As a separate component of that system, NCUA is required to define credit unions that are “complex” by reason of their portfolio of assets and liabilities and to develop a risk-based net worth requirement to apply to such credit unions in the “well capitalized” or “adequately capitalized” statutory net worth categories. The NCUA Board issued a proposed rule consisting of a three-step process for defining a “complex” credit union and for determining its risk-based net worth requirement under either of two methods. As revised to reflect public comments and to incorporate other improvements, the final rule narrows the definition of “complex” by minimum asset size and minimum risk-based net worth requirement; modifies the composition of certain risk portfolios; adjusts certain corresponding thresholds and risk weightings; and adds a risk mitigation credit.

DATES: Effective January 1, 2001.

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SUPPLEMENTARY INFORMATION:

A. BACKGROUND

1. The Credit Union Membership Access Act

On August 7, 1998, Congress enacted the Credit Union Membership Access Act, Pub. L. No. 105-219, 112 Stat. 913 (1998). Section 301 of the statute added a new section 216 to the Federal Credit Union Act, 12 U.S.C. 1790d (hereinafter referred to as "CUMAA" or "the statute" and cited as "§1790d"). Section 1790d requires the NCUA Board to adopt by regulation a system of "prompt corrective action" ("PCA") to commence when a federally-insured "natural person" credit union becomes undercapitalized. The statute designated three principal components of PCA: (1) a framework of mandatory actions prescribed by statute, §1790d(c), (e), (f) and (g), and discretionary actions developed by NCUA, which are indexed to five statutory net worth categories and their corresponding net worth ratios, §1790d(c); (2) an alternative system of PCA to be developed by NCUA for credit unions that CUMAA defines as "new," §1790d(a)(2); and (3) a risk-based net worth ratio to apply to credit unions that NCUA defines as "complex." §1790d(d). The third component alone is the subject of this final rule.

2. New Part 702 -- Prompt Corrective Action

Following the statutory mandate, the NCUA Board adopted as a final rule ("part 702") a comprehensive system of PCA consisting of a framework of mandatory and discretionary supervisory actions and an alternative system of PCA to apply to "new" credit unions. 12 C.F.R. 702 et seq. (2000); 65 FR 8560 (February 18, 2000).[1] For credit unions that do not meet the statutory definition of a "new" credit union, part 702 establishes a framework of mandatory and discretionary supervisory actions, indexed to the five net worth categories, and implements statutory conditions triggering conservatorship and liquidation. 12 C.F.R. 702.201 - 702.206. For credit unions that CUMAA defines as "new"—those having been in operation less than ten years and having $10 million or less in assets, §1790d(o)(4)—part 702 establishes a similarly-structured alternative system of PCA that recognizes that "new" credit unions initially have no net worth, need reasonable time to accumulate net worth, and must have incentives to ultimately become "adequately capitalized." §1790d(b)(2)(B). Under part 702, the net worth ratio and category of a credit union, whether "new" or not, are determined quarterly. 12 C.F.R. 702.101(a)(1), 702.302(a).

In addition to the substantive components of PCA, an independent appeal process is available to affected credit unions and officials to appeal decisions by NCUA

[1] Except for sections 702.103 through 702.108, which are the subject of this final rule, new part 702 takes effect August 7, 2000, and will first apply on the basis of data in the Call Report due to be filed January 22, 2001, reflecting activity in the fourth quarter of 2000.

staff imposing certain discretionary supervisory actions, and decisions by the NCUA Board reclassifying a credit union to a lower net worth category on safety and soundness grounds. 12 C.F.R. 747.2001 et seq. (2000). Part 702 also prescribes reserving and dividend payment requirements to conform to CUMAA's earnings retention requirement. §1790d(e); 12 C.F.R. 702.401 et seq.

3. Risk-Based Net Worth Requirement

Independently of the general system of PCA in part 702, CUMAA requires NCUA to develop a definition of a "complex" credit union based on the risk level of a credit union's portfolio of assets and liabilities, §1790d(d)(1), and to formulate a risk-based net worth ("RBNW") requirement to apply to credit unions meeting that definition. The RBNW requirement must "take account of any material risks against which the net worth ratio required for an insured credit union to be adequately capitalized [6 percent] may not provide adequate protection." §1790d(d)(2). NCUA was encouraged to, "for example, consider whether the 6 percent requirement provides adequate protection against interest-rate risk and other market risks, credit risk, and the risks posed by contingent liabilities, as well as other relevant risks. The design of the [RBNW] requirement should reflect a reasoned judgment about the actual risks involved." S. Rep. No. 193, 105th Cong., 2d Sess. 13 (1998) (S. Rep.).

These specifications reflect the Department of the Treasury's recommendation to Congress to require NCUA to develop a supplemental RBNW requirement "for larger, more complex credit unions . . . to take account of risks . . . that may exist only for a small subset of credit unions." U.S. Dept. of Treasury, Credit Unions (1997) at 71.

CUMAA demands that a credit union that meets the definition of "complex," and whose net worth ratio initially places it in either of the "adequately capitalized" or "well capitalized" net worth categories, must satisfy a separate RBNW requirement, which may exceed the minimum net worth ratio corresponding to its initial category (6 percent and 7 percent, respectively), in order to remain classified in that category.[2] §1790d(c)(1)(A)(ii) and (c)(1)(B)(ii). A "well capitalized" or "adequately capitalized" credit union that fails to meet its RBNW requirement is classified by statute in the "undercapitalized" net worth category, and will be subject to the mandatory and discretionary supervisory actions applicable to that category. §1790d(c)(1)(c)(ii).

CUMAA set August 7, 2000, as the deadline for issuing the final rule, and January 1, 2001, as its effective date. CUMAA §301(d)(2)(B) and (e)(2). Accordingly,

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2 The RBNW requirement also indirectly impacts credit unions in the "undercapitalized" and lower net worth categories, which are required to operate under an approved net worth restoration plan. The plan must provide the means and a timetable to reach the "adequately capitalized" category. §1790d(f)(5); 12 C.F.R. 702.206(c). However, for "complex" credit unions in the "undercapitalized" or lower net worth categories, the minimum net worth ratio "gate" to that category will be 6 percent or the credit union's RBNW requirement, if higher than 6 percent. In that event, a complex credit union's net worth restoration plan will have to prescribe the steps a credit union will take to reach a higher net worth ratio "gate" to that category. See 12 C.F.R. 702.206(c)(1)(i)(A).

the RBNW requirement for credit unions meeting the definition of “complex” will first apply on the basis of data in the Call Report due to be filed by quarterly filers on April 23, 2001, reflecting activity in the first quarter of 2001.

4. Rulemaking Process

As directed by CUMAA, NCUA commenced rulemaking by issuing an Advance Notice of Proposed Rulemaking (“ANPR”) which, among other things, both suggested and invited proposed concepts for an RBNW requirement and criteria for defining “complex.” CUMAA §301(d)(2)(A). 63 FR 57938 (October 29, 1998). By the comment deadline of January 27, 1999, NCUA received 34 comment letters from 32 commenters, the majority of which addressed the RBNW requirement.

On February 3, 2000, NCUA issued a proposed rule establishing a three-step process. 65 FR 8597 (February 18, 2000). The first step determined whether a credit union meets the definition of “complex.” The second step relied on Call Report data to determine a credit union’s RBNW requirement. The final step permitted a credit union to substitute certain alternative calculations that may reduce its RBNW requirement. The proposed rule discussed and reflected comments that NCUA had received in response to the ANPR. 65 FR at 8598-8599.

By the close of the comment period for the proposed rule, April 18, 2000, NCUA received 119 letters submitted by 113 public commenters (a few of whom submitted more than one comment). Comments were received from 42 federal credit unions, 26 state credit unions, 4 corporate credit unions, 21 state credit union leagues, 4 individuals serving as credit union directors, 4 credit union industry trade associations, an association of state credit union supervisors, 2 state financial institution regulators, and a bank which co-sponsors a collective investment fund for credit unions. In addition, comments were received from 2 consultants, 2 accounting firms, and 3 securities dealers and/or advisors, each of which serves credit union clients. A banking industry trade association also commented on the proposed rule.

A preponderance of commenters advocated a minimum asset size as a criterion for defining “complex,” and criticized labeling a credit union “complex” when its RBNW requirement is 6 percent or less. For the various risk portfolios, commenters generally suggested upward adjustments to the threshold levels and downward adjustments to the corresponding risk weightings; however, most provided no justification or empirical evidence to support the suggested adjustment. The unsupported comments are noted but not discussed in the preamble.[3] The handful of comments urging NCUA to abandon or ignore the purpose and criteria that Congress expressly prescribed for the RBNW requirement, and which NCUA lacks discretion to modify, are neither noted nor

[3] For this reason, references to the total number of comments received on a topic may not equal the number of comments specifically discussed in the preamble. In addition, nearly all comment letters contained multiple comments addressing various provisions of the proposed rule.

discussed in the preamble.[4] All other comments are analyzed generally in section C. below, except for the single banking industry trade association comment, which is addressed separately in section D.2. below.

B. PRINCIPAL DIFFERENCES BETWEEN PROPOSED RULE AND FINAL RULE

As revised to incorporate public comments and improvements initiated by NCUA staff, the final rule differs from the proposed rule in the following principal respects:

1. Applicability of RBNW requirement. The proposed rule featured a "four-trigger" test defining the term "complex" according to whether any one of four risk portfolios is exceeded by a corresponding threshold percentage of total assets. The final rule abandons that test in favor of a simple standard of applicability—an RBNW requirement is applicable, and must be met, only if a credit union's total assets exceed $10 million *and* its RBNW requirement exceeds 6 percent. §702.103.

2. Classification and weighting of "Investments" by weighted-average life. For purposes of defining "complex" and for calculating a credit union's RBNW requirement, the proposed rule generally identified an investment as long-term if its weighted-average life or next rate adjustment period was greater than three years. The final rule expands the proposed "Long-term investments" risk portfolio into a comprehensive "Investments" risk portfolio consisting of all investments permitted by law, regardless whether short- or long-term. §702.104(c). A weighted-average life is specified for each type of credit union investment. §702.105. When calculating the RBNW requirement, the contents of the "Investments" risk portfolio is classified among weighted-average life "buckets." Each bucket then receives a corresponding risk weighting. §§702.106(c), 702.107(c). Investments in CUSOs are defined as having a weighted-average life of greater than 1 year, but less than or equal to 3 years, §702.105(e), and are subsequently risk weighted at 6 percent. §702.106(c)(2).

3. Redefinition and zero weighting of "Low risk assets." The proposed "Low-risk assets" risk portfolio consisted of cash and cash equivalents and was risk weighted at 3 percent. The final rule moves cash on deposit in financial institutions and cash equivalents (e.g., investments with a maturity of 90 days or less)--which carry low risk--to the "Investments" risk portfolio, where they continue to be weighted at 3 percent. §702.106(c)(1). The "Low risk assets" risk portfolio is left to consist exclusively of cash on hand (e.g., coin and currency) and the National Credit Union Share Insurance Fund ("NCUSIF") deposit. §702.104(d). Because those assets carry virtually no risk, the final

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[4] For example, such comments advocated exempting from the RBNW requirement credit unions having a CAMEL "1" or "2" rating; urged NCUA to prescribe a 5 percent net worth ratio to be "well capitalized," as bank regulators do, even though CUMAA mandates a 7 percent minimum net worth for that category, §1790d(c)(1)(A); proposed limiting the RBNW requirement to off-balance sheet items; and urged approval of State rules allowing federally-insured, State chartered credit unions to grant member business loans to non-members.

rule reduces the risk weighting of that portfolio to zero. §702.106(d).

4. <u>5-year maturity and repricing threshold for "Long-term real estate loans</u>." The proposed "Long-term real estate loans" risk portfolio established a minimum maturity and repricing threshold of 3 years. The final rule increases the maturity and repricing threshold to 5 years in order to achieve general parity between consumer and real estate loans. §702.104(a). This will ensure a risk-weighting consistent with relative economic value exposure for all real estate loans (other than member business loans) that mature or reprice within 5 years, regardless of underlying real estate-related collateral. The 5-year threshold will omit a significant amount of home equity loans from this risk portfolio, yet still capture the majority of real estate loans with above average interest rate risk.

5. <u>Risk mitigation credit.</u> For credit unions that do not meet their RBNW requirement under the "standard calculation" or by using "alternative components," the final rule introduces a "risk mitigation credit." Under guidelines to be adopted by the NCUA Board, a credit union may apply for a credit to reduce the RBNW requirement to reflect mitigation of credit risk and/or interest rate risk. §702.108. The NCUA Board may, in its discretion, grant a risk mitigation credit based on quantitative evidence of mitigation.

C. SECTION-BY-SECTION ANALYSIS OF FINAL RULE

1. <u>Structural Overview</u>.

(a) <u>Three-step process</u>. The final rule retains in restructured form a three-step process, applicable to all federally-insured credit unions.[5] The first step, reflected in section 702.103, determines whether an RBNW requirement is applicable. The proposed rule defined a credit union as "complex" if any one of four "risk portfolios" exceed a corresponding "trigger" percentage of total assets. 65 FR at 8609. The final rule replaces the four-trigger test with a simple standard of applicability based on minimum asset size ($10 million) and a minimum RBNW requirement (more than 6 percent).

If an RBNW requirement is applicable, the second step, reflected in section 702.106, prescribes the "standard calculation," which relies on the eight risk portfolios identified in §702.104. Under the standard calculation, each of the risk portfolios is multiplied by one or more corresponding risk weightings to produce eight "standard components." (Risk weightings are applied to credit union investments by weighted-average life category, as specified in section 702.105.) The aggregate of the standard components equals the RBNW requirement a credit union must meet.

[5] Throughout the final rule, including the tables in the preamble and the rule text, and the appendices to subpart A which follow the rule text, the terms "credit union" and "CU" refer to federally-insured credit unions, whether federal- or State-chartered. 12 C.F.R. 702.2(c).

The third step, reflected in section 702.107, permits a credit union to substitute any of three specific "standard components" in section 702.106 with a corresponding "alternative component" that may reduce the RBNW requirement against which the credit union's net worth ratio is measured. The alternative components recognize finer increments of risk.

Finally, a "risk mitigation credit" is introduced in section 702.108 to permit a credit union that fails its RBNW requirement under the "standard calculation" (step 2), and as computed using the "alternative components" (optional step 3), to apply for a credit against its RBNW requirement, reflecting mitigation of credit risk or interest rate risk.

When the three-step process is completed, an "adequately capitalized" (6 to 6.99 percent net worth ratio) or "well capitalized" (7 percent or greater net worth ratio) credit union retains its original net worth category classification if its net worth ratio meets or exceeds its RBNW requirement under the standard calculation, or as computed using one or more alternative components, or as reduced by a "risk mitigation credit". An otherwise "adequately capitalized" or "well capitalized" credit union whose net worth ratio falls short of its RBNW requirement declines by one and two net worth categories, respectively, to the "first tier" of the "undercapitalized" category, §1790d(c)(1)(A)(ii) and (B)(ii), where it is subject to four mandatory supervisory actions. 12 C.F.R. 702.202(c).

(b) <u>Reliance on Call Report data</u>. For the following reasons, the NCUA Board has decided as a matter of policy to rely primarily on the objective data collected in the Call Report to administer PCA generally, and to implement the RBNW requirement in particular. First, use of the Call Report will minimize any additional recordkeeping burden and intrusion on credit unions because credit unions already file Call Reports either quarterly or semiannually. Second, Call Reporting is an efficient system of measurement that is an appropriate vehicle for implementing minimum risk-based capital requirements on an industry-wide scale. Third, the "PCA Worksheet" that will accompany the Call Report will permit credit unions to readily compare their net worth ratio and corresponding category classification with an applicable RBNW requirement at any time, rather than to depend on notice from NCUA. Fourth, reliance on objective numerical standards will ensure uniformity in measurement and enforcement of the RBNW requirement.

Beginning with the 4th quarter of 2000, the Call Report will be accompanied by a "PCA Worksheet" which extracts data from the Call Report to populate two different schedules.[6] The first will compute a credit union's net worth ratio. The second will perform the "standard calculation" to first determine whether an RBNW requirement is applicable, and if so, to determine whether it is met by the credit union's net worth ratio. Independent of the Call Report, a separate form will be available to calculate the

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[6] December 1999 data indicates that all but 60 credit unions with assets of $10 million or more file their Call Reports electronically and, therefore, will benefit from the electronic flow of data from the Call Report to the accompanying "PCA Worksheet."

"alternative components" to determine if any reduce the RBNW requirement under the standard calculation.

Numerous commenters have encouraged NCUA to substantially expand and modify the Call Report on the theory that enhanced precision in the collection of PCA-related data would give them a greater opportunity to demonstrate mitigation of balance sheet risk. However, mandating such additional detail in the Call Report would increase the reporting burden for all credit unions while any resulting augmented level of precision would benefit a small minority. For this reason, NCUA plans only incremental expansion and modification of the Call Report as warranted by experience in implementing PCA. To that end, the NCUA Board adopts the practice of occasionally sacrificing precision for some in favor of simplicity for all.

Other commenters have encouraged NCUA to conduct a subjective assessment of credit unions' success, through modeling and other risk management techniques, to mitigate credit and interest rate risk, in spite of what an RBNW requirement may indicate. In this regard, the NCUA Board prefers not to circumvent the final rule's reliance on Call Report data as reflected in the "PCA Worksheet." However, NCUA will evaluate quantitative evidence of risk mitigation submitted by those credit unions that apply for a risk mitigation credit. §702.108.

2. Section 700.1(i) – Withdrawal of definition of "risk assets."

The proposed rule failed to delete part 700's definition of "risk assets" to reflect the repeal of section 116 of the Federal Credit Union Act ("FCUA"), 12 U.S.C. 1762. Current section 700.1(i) defines the term "risk assets" exclusively "[f]or the purpose of establishing the reserves required by section 116 of the [FCUA]." Former section 116 required a credit union to transfer a percentage of gross income to its regular reserve until the reserve equaled a prescribed percentage of the credit union's outstanding loans and risk assets. Former part 702 prescribed rules for implementing the statutory requirement to establish and maintain a regular reserve. CUMAA repealed section 116 of the FCUA. CUMAA §301(f)(3). Former part 702 is in force under separate statutory authority until August 7, 2000—the effective date of new part 702, 65 FR 8560, which implements CUMAA's earnings retention requirement. See 12 U.S.C. 1790d(e). Under new part 702, neither PCA generally, nor the RBNW requirement specifically, utilizes the concept or the term "risk assets." Accordingly, the final rule abolishes that term as obsolete.

3. Section 702.2(k) – Definition of weighted-average life.

Both the standard component and the alternative component for "Investments" categorize investments according to weighted-average life for purposes of risk weighting. §§702.106(c), 702.107(c). The proposed rule defined "weighted-average life" ("WAL") as the "time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received, and then summing and dividing by the total amount of principal." 65 FR at 8068. See

Fabozzi, Frank, and T. Dessa, eds., The Handbook of Fixed Income Securities (5th ed. 1997) (hereinafter “Fabozzi”) at 539.

Twenty-two commenters addressed the proposed definition of WAL. All were content to use WAL to characterize relative interest rate risk, but ten preferred using “effective duration” or “modified duration” instead,[7] reasoning that they are more refined measures of interest rate risk exposure. In contrast, one commenter supported using the remaining term to maturity of the investment.

NCUA concedes that “effective duration,” appropriately calculated, can be a more refined measure of interest rate risk exposure. In contrast, using remaining term to maturity, although simple, can dramatically overstate the risk of certain investments. Examination experience indicates that WAL provides a fair indicator of interest rate risk exposure for typical credit union investments. Furthermore, the current Call Report requires investments to be reported according to WAL. To change the basis for reporting investments in Schedule C of the Call Report would be unduly disruptive to the process of acclimating to PCA.

One commenter urged NCUA to go beyond a general WAL definition and establish approved methodologies and sources for determining WAL. NCUA believes this is unwarranted because the definition as proposed is sufficiently clear. Reliable models, and reasonable and supportable estimates of the time periods for cash flows, are readily available from investment industry sources. In addition, to establish a process for approving WAL sources and methodologies would be burdensome and unnecessarily intrusive.

The final rule retains the general WAL definition as proposed, §702.2(k); however, to facilitate classification by WAL in the standard and the alternative components for “investments,” the final rule specifies the WAL for certain categories of credit union investments. §702.105.

4. Section 702.103 – Applicability of risk-based net worth requirement.

To decide which credit unions must comply with “an applicable risk-based net worth requirement,” §§702.101(a)(2), 702.102(a), 702.302(a), the proposed rule (in former § 702.104) featured a “four-trigger” test defining a credit union as “complex” if its holdings in any of four “risk portfolios,” representing above-average risk, exceeded a corresponding “trigger” percentage of its total assets. 65 FR at 8609. This provision drew 124 comments—more than all but one other provision of the proposed rule—

[7] “Effective duration” and “modified duration” are estimates of the percentage price change of an investment for a one percent change in interest rates. See Fabozzi at 104. “Duration” provides a time measure of when on average the cash flows of an investment are received based on the present value of the cash flows, rather than on the actual amounts to be received in the future. See Woelfel, Charles J., ed., Encyclopedia of Banking and Finance (10th ed. 1994) at 317.

generally falling into three categories: those seeking to elevate the proposed "trigger" percentages, those critical of the test's methodology; and those preferring entirely different criteria for determining whether an RBNW requirement is applicable.

Addressing the trigger percentages of total assets, ten commenters urged raising the proposed 25 percent trigger for the "Long-term real estate loans" portfolio to between 30 and 50 percent, contending that a low percentage trigger would discourage lending. Two commenters disputed the validity of NCUA's reliance on comparable thrift institution data on long-term real estate loans to justify the 25 percent trigger. Nineteen commenters advocated increasing the proposed 12.25 percent trigger for the portfolio combining "Member business loans outstanding" and "Unused member business loan commitments," generally surmising that the 12.25 percent trigger was arbitrarily borrowed from elsewhere in CUMAA. See 12 U.S.C. §1757a(a). Thirty-three commenters supported increasing the proposed 15 percent trigger for the "Long-term investments" portfolio to between 20 and 33 percent, citing the importance of investment income to profitability when loan volume is low. One commenter suggested setting the trigger percentages based on the decline in portfolio value based on gradual periodic rate increases, rather than based on a 300 basis point "rate shock." Six commenters insisted upon raising the proposed 5 percent trigger for the "Loans sold with recourse" portfolio to at least 10 percent of total assets, leaving a single commenter who was content with the 5 percent trigger.

Addressing the methodology of the proposed four-trigger test, seven commenters insisted that a credit union should be deemed to meet the definition of "complex" only if it exceeds one or more of the trigger percentages for a period of consecutive quarters, not just a single quarter. Under this scenario, the RBNW requirement would be a lagging indicator of risk, inconsistent with the purpose of PCA. Ten commenters suggested merging the "Long-term real estate loans" and "Long-term investments" portfolios under a single threshold ranging between 30 and 60 percent of total assets. Going further, another commenter proposed merging all four portfolios representing above-average risk under a single omnibus trigger percentage.

Notably, a substantial number of commenters appealed to the NCUA Board to replace the four-trigger test altogether. Thirty-one commenters sought to establish in its place a minimum asset "floor" as a criterion for defining "complex," reflecting the minimal level of risk to the NCUSIF posed by the aggregate assets of credit unions below a certain asset size. Commenters suggested setting that floor at amounts ranging from $5 million to $100 million in assets. In contrast, two commenters objected to the exclusion of credit unions based on asset size.

Taking an alternative approach, nineteen commenters suggested defining as "complex" only those credit unions that have an RBNW requirement exceeding 6 percent. This would entail a reversal in sequence--instead of requiring only those credit unions that meet the definition of "complex" to calculate and meet an RBNW requirement, all credit unions would have to review an RBNW calculation to determine if they exceed 6 percent. Those with an RBNW requirement in excess of 6 percent would be deemed “complex” and then must meet that requirement. Departing even further from the four-trigger test, another commenter apparently would have all credit unions calculate an RBNW requirement, but only those which ultimately fail to meet that requirement, *whether more or less than 6 percent*, would be designated “complex.” Regardless which approach is adopted in the final rule, five commenters implored NCUA to minimize, if not to abandon, use of the statutory term “complex” due to what they perceive as its pejorative connotation.

The difference of opinion among commenters over the appropriate criteria for defining a “complex” credit union has caused the NCUA Board to review the statutory criteria for designing the RBNW requirement, §1790d(d); to assess the impact of the four trigger-test compared to commenters’ suggested alternatives, based on the most recent Call Report data; and to consider which approach will, in the end, most efficiently capture the risks to the NCUSIF that are the intended target of the RBNW requirement. In addition, the NCUA Board shares commenters’ concern that a significant number of credit unions that met the definition of “complex” under the four-trigger test had an RBNW requirement of 6 percent or less. This reevaluation has persuaded the NCUA Board to abandon the four-trigger test in favor of a simple standard of applicability that combines minimum asset size and a minimum RBNW requirement.

Accordingly, the final rule provides that “a credit union is defined as ‘complex’ and an RBNW requirement is applicable” only if its total assets exceed $10 million *and* its RBNW requirement under the standard calculation exceeds 6 percent.[8] §702.103. Both measures rely on quarter-end total assets as reflected in a credit union’s most recent Call Report filed either quarterly or semiannually.[9] Wherever possible, the final rule uses the statutory term “applicable risk-based net worth requirement,” e.g., §1790d(c)(1)(B)(ii) instead of the statutory label “complex.” An RBNW is not “applicable” to a credit union that does not meet both criteria; its net worth category classification is decided solely by its net worth ratio.

(a)(1) Minimum asset size. The prerequisite $10 million asset “floor” imposed in the final rule reflects the conclusion that the aggregate assets of credit unions in that asset bracket do not expose the NCUSIF to material risk. CUMAA directed NCUA to develop an RBNW requirement that “take[s] account of any *material risks* against which the net worth ratio required for an insured credit union to be adequately capitalized [6 percent] may not provide adequate protection.” §1790d(d)(2) (emphasis added); S. Rep. at 13 (1998). Aggregate insured shares of credit unions with $10 million or less in assets equal $17,269,585,004, or 5.15 percent of all insured shares. Of the 6195 credit unions in this asset bracket, currently 105 would be subject to an RBNW requirement under §702.103(a)(2), representing $423,344,277 in insured shares. This would be the

[8] The final rule effectively exempts “new” credit unions under subpart C from being defined as “complex” and subject to an RBNW requirement because, by definition, they have $10 million or less in assets. Compare §§702.310(b) and 702.103(a)(2). Therefore, the final rule deletes references to an RBNW requirement for “new” credit unions from sections 702.302(a) and (c) in subpart C.

[9] When part 702 or the Call Report refers to total assets at quarter-end, it means the month-end balance as of the end of a calendar quarter. E.g., §§702.2(j)(1)(i) and (iv), 702.104, 702.106, 702.107.

NCUSIF's maximum exposure in a worst case scenario that assumes all 105 credit unions with assets of $10 million or less fail and the NCUSIF is forced to absorb losses at the rate of 100 cents to the dollar. By comparison, today only 5 of the 105 credit unions meeting the definition of "complex" in that asset group would fail their RBNW requirement under the standard calculation. Under typical circumstances, the NCUSIF's risk exposure from credit unions with $10 million or less in assets is insufficient to be considered material.

With a sacrifice of minimal risk protection, the $10 million asset floor dramatically reduces the burden the RBNW requirement would impose. Credit unions with assets of $10 million or less number 6195, representing 58 percent of all credit unions. Thus, the $10 million asset floor relieves the majority of credit unions of any burden whatsoever associated with an RBNW requirement.

The $10 million asset floor parallels use of a $10 million measure elsewhere in CUMMA to trigger other PCA provisions. A maximum of $10 million in assets is one criterion of the statutory definition of a "new" credit union, which is subject to an alternative system of PCA. §1790d(o)(4). CUMAA requires NCUA to provide assistance in preparing net worth restoration plans to credit unions having less than $10 million in assets. §1790d(f)(2). In addition, excluding credit unions beneath the $10 million asset floor is consistent with the Treasury Department recommendation that led Congress to enact an RBNW component of PCA--that it is needed "for larger, more complex credit unions . . . to take account of risks . . . that may exist only for a small subset of credit unions." U.S. Dept. of Treasury, Credit Unions (1997) at 71.

(a)(2) Minimum RBNW requirement. The minimum 6 percent RBNW "floor" which the final rule imposes on credit unions with assets above $10 million reflects the conclusion that credit unions whose RBNW requirement is 6 percent or less fall outside the intended target of the RBNW requirement. CUMAA is explicit in concentrating the RBNW requirement on "material risks against which the [6 percent] net worth ratio required . . . to be adequately capitalized may not provide adequate protection." §1790d(d). Further, NCUA was instructed to "consider whether the 6 percent requirement provides adequate protection against . . . relevant risks." S. Rep. at 13. The NCUA Board has determined that a 6 percent net worth ratio is sufficient to protect against an average level of risk, but that a measure of additional net worth is needed to compensate for risks which are above average. For this reason, the final rule limits the scope of its RBNW requirement to credit unions that have an above average level of risk exposure.

Under the proposed rule, all credit unions, through the "PCA Worksheet," were required to conduct the four trigger test, and once meeting the definition of "complex," were required to calculate and meet an RBNW requirement. 65 FR at 8609. With the minimum 6 percent RBNW floor, that process is reordered as explained above; all credit unions with assets above $10 million will now have to review a standard RBNW calculation reflected in the "PCA Worksheet" to determine whether the result exceeds 6 percent. If so, the RBNW requirement is applicable and must be met; if not, an RBNW requirement is not applicable and the credit union retains its original net worth category classification. Although all credit unions with assets above $10 million now will have to *review* an RBNW calculation, fewer will be required to *meet* an RBNW requirement.

Primarily as a result of the final rule's $10 million asset floor, it is estimated that 452 credit unions will be required to meet an RBNW requirement under the final rule--less than one-third the number required to do so under the proposed rule. <u>See</u> section E below.

(b) <u>Optional Call Report filing</u>. The proposed rule required the RBNW requirement to be determined according to a credit union's Call Report schedule--quarterly for quarterly filers, and semiannually for semiannual filers. 65 FR at 8599. <u>Compare</u> 12 C.F.R. 702.101(a) (quarterly determination of net worth and corresponding category). One commenter protested that this would deprive semiannual filers of the means to demonstrate either that an RBNW requirement no longer is applicable, or that their RBNW requirement has declined (and perhaps has been met) in the 1st and 3rd quarters. Another commenter proposed a solution--optional 1st and 3rd quarter Call Report filing for semiannual filers. Another would mandate quarterly Call Report filing by all credit unions that meet the definition of "complex."

Mandatory quarterly Call Report filing for credit unions that meet the definition of "complex" currently is not warranted; however, NCUA concurs that optional 1st and 3rd quarter Call Report filing would give those credit unions maximum flexibility. The final rule is modified accordingly. §702.103(b).

5. <u>Section 702.104 -- Risk portfolios defined.</u>

The proposed rule (in former §702.103) established eight "risk portfolios," representing various levels of risk. 65 FR at 8608. The portfolios consist of assets, liabilities and contingent liabilities, as reflected in Call Report data to be collected in the "PCA Worksheet" accompanying the Call Report. In subsequent sections, the contents of each risk portfolio will be multiplied by one or more corresponding risk weightings. The final rule retains the eight proposed risk portfolios, modified as follows in section 702.104 (<u>see</u> Table 1 in §702.104):

(a) <u>Long-term real estate loans</u>. The proposed risk portfolio for "Long-term real estate loans" consisted of all fixed-rate real estate loans and lines of credit that mature or reprice in greater than 3 years. 65 FR at 8608. NCUA examination experience and research confirmed that a vast majority of member loans with above average exposure to interest rate changes are real estate related. 65 FR at 8600. The 124 overlapping comments addressing this provision generally seek either to increase the 3-year maturity and repricing threshold or to narrow the composition of the portfolio by excluding certain types of loans.

Forty-eight commenters urged an increase in the 3-year maturity and repricing threshold to either 5 or 7 years on various grounds. Although careful not to advocate an augmented risk portfolio for consumer loans, the majority of commenters protested that a threshold as low as 3 years discriminates against real estate loans compared with consumer loans, even though they have similar economic value exposure,[10] indicating little difference in interest rate risk. The commenters predicted that this unequal treatment would cause credit unions to migrate to consumer lending at the expense of real estate lending in order to elude this risk portfolio. This would result in an increase in credit risk exposure due to the generally better performance and more stable collateral of real estate loans when compared with consumer loans. On similar grounds, nineteen commenters urged NCUA to exclude home equity loans with maturities of fewer than 6 or 7 years.

Commenters supporting a 5-year maturity and repricing threshold for this portfolio observed that NCUA adopted a 5-year threshold in its pre-PCA definition of "risk assets." 12 C.F.R. §700.1(i); but see section C.2. above. Others pointed elsewhere in the proposed rule, observing that the alternative component for "Long-term real estate loans" features a 3-to-5 year remaining maturity bucket that receives the risk weighting designated for average risk assets (6 percent). In contrast, a single commenter was content with the 3-year threshold, and another went even further to boldly suggest applying it to consumer loans as well.

With regard to the composition of the "Long-term real estate loans" portfolio, a commenter suggested excluding loans having a government guarantee against default. While a guarantee against default mitigates credit risk, it does not affect interest rate risk. Because this portfolio measures primarily interest rate risk, it is appropriate that long-term, government guaranteed loans remain in this risk portfolio.

Seeking a means to demonstrate risk mitigation, twenty-three commenters wished to exclude loans, or even the whole portfolio, upon proof that "matching" loans against liabilities or "hedging" through derivatives mitigates corresponding balance sheet risk. Fourteen commenters wanted to adopt WAL instead of contractual maturity to report real estate loans because WAL is more accurate and would reflect anticipated mortgage loan prepayments. If adopted, both suggestions would substantially narrow the scope of this risk portfolio.

NCUA concedes that "matching" and "hedging" are prudent risk management tools, and that WAL is a potentially more accurate measure of risk exposure. As explained in section C.1(b) above, the NCUA Board has decided as a matter of policy to rely on objective data captured in the Call Report and reflected in the "PCA Worksheet" as the most efficient means to implement PCA. For this reason, the final rule neither incorporates WAL in the "Long-term real estate loans" risk portfolio, nor excludes

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[10] "Economic value exposure" refers to price sensitivity of a credit union's assets (changes in the value of the assets over different interest rate/yield curve scenarios). NCUA Interpretive Ruling and Policy Statement No. 98-2, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," 63 FR 24097, 24101 (May 1, 1998).

“matched” or “hedged” loans.[11]

Two commenters recommended that this portfolio combine mortgage-backed securities with long-term real estate loans. Due to the similarity in risk characteristics, NCUA concurs that this is the preferred business practice to manage balance sheet risk on an aggregate basis (See NCUA Letter to Credit Unions No. 99-CU-12, “Real Estate Lending and Balance Sheet Risk Management,” August 1999); however, since aggregate measurement is less accurate than measurement of the specific components, and would impose an undue burden on some credit unions to estimate reliable prepayment assumptions, NCUA declines to mandate the practice for all credit unions.

Seeking a fundamental modification, three commenters recommended applying the three-year contractual maturity exclusion to the scheduled principal payments of all real estate loans. This is unnecessary because scheduled principal repayments are already taken into consideration in the risk weighting assigned as a result of NCUA’s evaluation of the potential economic value exposure of long-term real estate loans.

To achieve general parity among all types of loans, the final rule increases the maturity and repricing threshold for the “Long-term real estate loans” risk portfolio to 5 years. §702.104(a). This will ensure a risk-weighting consistent with relative economic value exposure for all types of loans (other than member business loans) that mature or reprice within 5 years, regardless of underlying collateral. The 5-year threshold will omit a significant amount of home equity loans from this risk portfolio, yet still capture the vast majority of real estate loans with above average interest rate risk.

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(b) Member business loans outstanding. The proposed risk portfolio for “Member business loans outstanding” consisted of loans outstanding that qualify as member business loans (“MBLs”) under NCUA’s definition, 12 C.F.R. 723.1, or under a State’s NCUA-approved definition. 65 FR at 8608. Unused MBL commitments were expressly excluded because they are addressed in a separate risk portfolio, §702.104(g).

NCUA received several comments generally seeking to exclude certain MBLs from this risk portfolio. Eleven commenters sought to exclude portions of MBLs that are government guaranteed, and six urged excluding portions with credit enhancements, such as those secured by shares or deposits in a federally-insured financial institution, or guaranteed by a non-governmental organization. NCUA’s rule on MBLs (“Part 723”) already excludes from the loans-to-one-borrower limit, §723.8, portions of an MBL that are either: “fully or partially” government guaranteed; subject to a government’s advanced commitment to purchase; or fully secured by shares or deposits in a federally-insured financial institution. §723.9(a)(3). See also §723.1(b)(4), 64 FR

[11] Federally-chartered “natural person” credit unions may apply to participate directly, or through a corporate credit union acting as a vendor, in an interest-rate-risk-hedging program involving derivative transactions. 12 C.F.R. 703.140. Corporate credit unions may apply under Appendix B to 12 C.F.R. 704 for expanded authorities to engage in derivative transactions.

28721, 28722 (May 27, 1999). Consistent with part 723, NCUA declines to exclude MBLs guaranteed by a non-governmental organization from the “Member business loans outstanding” risk portfolio.

Purporting to seek further consistency with part 723, five commenters insisted upon excluding those MBLs having an aggregate *remaining* balance equal to or less than $50,000. §723.1(b)(3). However, the NCUA Board has determined that part 723’s $50,000 threshold is measured against the *original* balance of the loan at the time it is originated, not its subsequent remaining balance. If a loan qualifies as an MBL when it is originated, its remains so until it has been repaid in full, sold, or otherwise disposed of.

Four commenters urged excluding loans secured by real estate from this risk portfolio, contending that long-term fixed-rate MBLs belong in the “Long-term real estate loans” risk portfolio because not all MBLs are long-term and fixed-rate. This would potentially lead to a higher than necessary risk weighting for shorter-term MBLs. Similarly, four commenters suggested excluding loans secured by automobiles, as well as loans with maturities less than 3 years, asserting that they belong in the “Average risk assets” risk portfolio because such loans present minimal interest rate risk. Part 723 defines an MBL as any loan, line of credit, or letter of credit where the proceeds are used for commercial, corporate or agricultural purposes, or for other business investment property or venture. §723.1(a). A loan that is fully secured by a lien on a 1 to 4 family dwelling that is the member’s primary residence is *not* an MBL. §723.1(b)(1). Such a loan would be included in either the “Long-term real estate loans” risk portfolio or the “Average risk assets” risk portfolio depending on its remaining maturity. Part 723 also excludes other loans from its definition of an MBL, §723.1(b)(2)-(5), which would be included in the “Average risk assets” portfolio.

Finally, a single commenter sought to eliminate the “MBLs outstanding” risk portfolio altogether on ground that CUMAA did not explicitly mandate additional net worth for MBLs. In fact, CUMAA did not identify any particular assets warranting additional net worth; rather, the statute instructed NCUA to generally identify credit unions which meet a definition of “complex” based on their portfolios of assets and liabilities and to design an RBNW requirement that takes account of material risks not addressed by a 6 percent net worth ratio.

The final rule retains the “Member business loans outstanding” risk portfolio without modification. §702.104(b).

(c) <u>Investments</u>. The proposed risk portfolio for “Long-term investments” (here renamed simply “Investments”) consisted of investments with a WAL greater than 3 years or which reprice more frequently than 3 years, and investments in a collective investment fund or a registered investment company. 65 FR 8608. NCUA research and experience indicated that such investments have greater economic value exposure to interest rate changes than do investments with shorter terms. 65 FR at 8600. Investments which fell below the threshold for this portfolio qualify for either of the proposed “Low risk assets” or “Average risk assets” risk portfolios.

The 46 commenters who addressed this risk portfolio fall into two categories--those challenging the 3-year WAL and repricing threshold, and those who contend that certain investments belong in other risk portfolios. Forty-two insisted upon raising the threshold to between a low of 4 years and a high of 10 years, although few provided any rationale for the adjustment. In contrast, one commenter cited valuation modeling confirming that the 3-year threshold is reasonable. NCUA maintains that the 3-year WAL threshold is valid according to valuation modeling of fixed-rate investments. 65 FR 8600.

In regard to composition of the portfolio, one commenter suggested reducing the dollar balances of investments above the 3-year threshold by the amount of projected amortizations within 3 years. Another would offset that balance by the amount of investments having a WAL of less than one year. Two commenters proposed to exclude investments classified as “available-for-sale” under Statement of Financial Accounting Standards No. 115 (“SFAS 115”) on the theory that marking-to-market takes into account their current market values. NCUA disagrees, however, because these investments have potential interest rate risk and the current mark-to-market is not reflected in net worth, which is generally limited to retained earnings. §702.2(f); <u>See also</u> 65 FR at 8565. To put different assets in parity with each other, thirteen commenters insisted on putting investments with a WAL of less than one year in the “Low risk assets” portfolio.

NCUA concurs with commenters that the RBNW requirement should treat similar investments similarly in terms of risk, and has determined that the most comprehensive and efficient means to that end is to define investments at the outset by WAL only, as specified in §702.105, and to subsequently apply the same risk weighting to all investments in the same WAL category. To implement this fundamental modification to the proposed rule, the final rule eliminates altogether the WAL and repricing threshold to distinguish long-term from short-term investments. Instead, the risk portfolio for investments is now expanded to consist of all investments permitted by law for federally-insured credit unions, including investments in CUSOs. §702.104(c). To reflect this modification, this risk portfolio is renamed simply “Investments.”

(d) <u>Low-risk assets</u>. The proposed risk portfolio for “Low risk assets” consisted of cash and cash equivalents as defined by Generally Accepted Accounting Principles (“GAAP”). 65 FR at 8608. GAAP generally interprets cash equivalents as investments with remaining maturities of 3 months or less. 65 FR at 8600 n.6.

Thirty commenters insisted that cash be treated as a “no risk asset” so that it receives a risk weighting of zero, instead of the 3 percent weighting that the proposed rule applied to this portfolio. Similarly, fourteen commenters inquired why a credit union’s NCUSIF deposit was not also treated as a “no risk asset.” Three commenters asserted that mutual funds with portfolios maturing within 90 days constitute cash equivalents and should be classified as “Low risk assets.”

NCUA agrees that cash held by a credit union for normal operations--such as vault cash, ATM cash and teller cash--typically presents no risk because it is protected from loss by a credit union's fidelity bond. However, cash equivalents such as demand deposits and short-term investments at other financial institutions carry some degree of credit risk when they exceed applicable insuring limits. In contrast, the NCUSIF deposit clearly poses no credit risk to the NCUSIF or to the credit union. Further, although the NCUSIF deposit represents 1 percent of insured shares and deposits on a credit union's balance sheet, it typically is augmented by a maximum of 30 basis points in NCUSIF retained earnings. This 30 basis point cushion is available to absorb losses before the NCUSIF deposit would be impaired.

To distinguish no risk assets from low risk assets, the final rule deletes cash on deposit in financial institutions and cash equivalents (e.g., investments with a maturity of 90 days or less) from the "Low risk assets" portfolio, effectively shifting them to the "Investments" risk portfolio, where they will subsequently be categorized in the one year or less WAL bucket and weighted at 3 percent. See §§702.106(c)(1), 702.107(c)(1). Cash on hand and the NCUSIF deposit remain in the "Low risk assets" risk portfolio, §702.104(d); however, because those assets carry no appreciable risk, the final rule reduces to zero the risk weighting subsequently given to that portfolio in the corresponding standard component. §702.106(d).

(e) Average-risk assets. The proposed risk portfolio for "Average risk assets" consists of assets which do not fall within the scope of any other risk portfolio because such assets are neither below nor above average in risk. 65 FR at 8608. This portfolio typically includes consumer loans, short-term real estate loans and fixed assets, 65 FR at 8600, and is subsequently weighted at 6 percent to reflect the 6 percent net worth ratio required to be classified "adequately capitalized."

Two commenters argued that fixed assets should be put in the "Low risk assets" risk portfolio because land and buildings typically increase in value. However, NCUA research shows that credit unions with high levels of fixed assets on average have lower net income.

Addressing investments which had been subject to the proposed rule's 3-year WAL and repricing threshold--since abandoned--sixteen commenters argued that investments having a WAL of less than 1 year appropriately belong in the "Low risk assets" portfolio, where they would be weighted at 3 percent instead of 6 percent. Twenty-three commenters believed that mutual funds with a WAL of less than one year --which had been included in the proposed "Long-term investments" portfolio regardless of WAL or repricing date--also belong in this portfolio. The final rule addresses these suggestions elsewhere by classifying all investments by WAL, as specified in §702.105, and applying a corresponding risk weighting, §§702.106(c), 702.107(c). Because the "Average risk assets" risk portfolio contains only those assets that do not belong in the risk portfolios discussed in sections 5.(a) through (d) above, the final rule retains the "Average risk assets" risk portfolio without modification. §702.104(e).

(f) Loans sold with recourse. The proposed risk portfolio for "Loans sold with recourse" consisted of a credit union's outstanding balance of loans sold or swapped with recourse. 65 FR at 8608. As contingent liabilities, they are an off-balance sheet item and, therefore, do not fall in any of the other risk portfolios.

To avoid what was perceived as double-counting, seven commenters favored deducting recourse loans from this portfolio to the extent that they already have been reserved for through the provision for loan and lease losses expense in accordance with GAAP. NCUA disagrees because the "Allowance" standard component gives an offsetting credit for the Allowance for Loan and Lease Losses, §702.106(h); thus, there is no redundant reserving. Loans sold with recourse are treated no differently than on-balance sheet loans that also require GAAP reserving but still receive a minimum 6 percent risk weighting. See 702.106(a)(1).

Two commenters asserted that this risk portfolio should include only the portion of a loan that is subject to recourse against the credit union. The final rule does not recognize partial recourse because the Call Report does not collect data in sufficient detail to distinguish partial from full recourse. See "Risk Based Capital Standards; Recourse and Direct Credit Substitutes," 65 FR 12320, 12344 (March 8, 2000) (proposal to require banks to maintain capital against full amount of assets supported by a partial recourse obligation).

One commenter requested corroboration on the risk exposure associated with recourse loans. NCUA maintains that examination experience with credit unions' limited activity in this area thus far suggests that the credit risk exposure associated with recourse loans is analogous to that associated with similar loans retained on the balance sheet. See 65 FR at 8601. In this regard six commenters urged NCUA to collect more detailed data to measure incremental levels and conditions of associated risk exposure. NCUA concurs that this information would be useful in developing risk gradations, identifying potential exclusions, and differentiating loans with only partial recourse. At present, however, only 55 credit unions report any recourse loan activity. Until this activity expands significantly, NCUA prefers to keep the burden and level of detail in recourse loan reporting to a minimum.

The proposed rule's silence about loans sold in the secondary mortgage market prompted a commenter to request NCUA to clarify whether such loans are considered loans sold with recourse. In response, the final rule expressly excludes loans sold to the secondary mortgage market that feature representations and warranties customarily required by the U.S. Government (e.g., Ginnie Mae) and government-sponsored enterprises (e.g., Fannie Mae, Freddie Mac). §702.104(f). These include warranties that the credit union has underwritten the loan and appraised the collateral in conformity with identified standards. These warranties provide for the return of assets in instances of incomplete documentation or fraud. However, credit enhancing representations and warranties beyond the usual agency requirements are considered recourse and, therefore, are not excluded from this risk portfolio. The "Loans sold with recourse" risk portfolio is otherwise retained as proposed.

(g) Unused member business loan commitments***.*** The proposed risk portfolio for "Unused member business loan commitments" segregates unused MBL commitments from actual loans because commitments represent off-balance sheet, contingent liabilities. 65 FR at 8608. Large draws on unused MBL commitments may cause liquidity problems and heighten exposure to credit risk. 65 FR at 8601.

Attempting to demonstrate a lower level of credit risk, two commenters wished to discount an unused commitment when it is revocable, e.g., on grounds of a "material adverse condition." However, examiner experience indicates that MBL commitments typically do not feature a "material adverse conditions" clause as grounds for revocation.

From a different approach, three commenters proposed discounting unused commitments by half due to the unlikelihood that all of a credit union's unused commitments would be drawn upon simultaneously. As explained above, part 723 does not discount or reduce a loan's original balance when aggregating MBLs or unused commitments to apply the $50,000 exclusion under section 723.1(b)(3). To remain consistent with part 723, the final rule retains this risk portfolio as proposed. §702.104(g). Commenters' observations already are reflected in the lower risk weighting (6 percent) the standard calculation applies to the *entire* contents of the "Unused member business loan commitment" portfolio, §702.106(g), compared to the 12 percent risk weighting it applies to the proportion of the "Member business loans" risk portfolio in excess of 12.25 percent of total assets. §702.106(b)(2).

(h) Allowance***.*** As proposed, the "Allowance " risk portfolio provides a credit of 100 percent of a credit union's Allowance for Loan and Lease Losses ("ALL") not to exceed the equivalent of 1.5 percent of total loans. 65 FR at 8609. This credit is given to recognize that a credit union's ALL already mitigates risk.

The commenters were at odds in addressing the composition of the "Allowance" portfolio. One commenter suggested expanding the "Allowance " portfolio to include the "Allowance for investment losses," apparently unaware that SFAS 115 eliminated the need for that account. In bold contrast, another favored doing away with the portfolio altogether, objecting that it unnecessarily complicates the rule.

A single commenter suggested that the "Allowance" portfolio consist of the equivalent of a fixed 1.5 percent of loans regardless whether a credit union's actual ALL is less than 1.5 percent of total assets. In that event, a credit union would receive a credit to reduce its RBNW requirement for reserves that it does not actually have.

The other commenters challenged the portfolio's maximum of 1.5 percent of total loans. Several predicted that it will be a disincentive to fund the ALL above the equivalent of that ceiling. This claim is not persuasive, however, because credit unions are bound by GAAP and §702.401(d) to compute the ALL accurately and in good faith, without regard to maximizing the credit derived from the "Allowance" risk portfolio. In any event, NCUA research indicates that two-thirds of all credit unions' ALL does not reach 1.5 percent of total loans.

The "Allowance" risk portfolio recognizes the credit risk mitigation resulting from reserving for losses in the ALL. Yet reserves in excess of 1.5 percent of total loans reflect higher than typical levels of credit exposure. 65 FR at 8601. To capture this higher risk, the ceiling on the "Allowance" risk portfolio remains intact in the final rule. §702.104(h).

6. Section 702.105 – Weighted-average life of investments.

Both the standard component and the alternative component for "Investments" categorize the contents of the corresponding risk portfolio according to weighted-average life for purposes of risk weighting. §§702.106(c), 702.107(c). For this purpose, section 702.2(k), discussed above, provides a general definition of WAL. Section 702.105 prescribes rules for determining the WAL of certain investments (see Table 2 in §702.105).

(a) Registered investment companies and collective investment funds. The proposed rule made an exception to the general WAL definition only for investments in registered investment companies or collective investment funds (other than money market mutual funds), assigning them a WAL of greater than 5 years, but less than or equal to 7 years. 65 FR at 8608.

Commenters who addressed the single proposed exception for registered investment companies and collective investment funds insisted that the target or maximum WAL disclosed in a prospectus or trust instrument is the most accurate measure of interest rate risk. NCUA concurs in this suggestion, but prefers to use maximum disclosed WAL because a mutual fund's actual WAL may exceed its stated target.

The maximum WAL may be disclosed directly, or indirectly by reference to a maximum duration no greater than that of a bullet security (i.e., a security with all principal due at maturity). A bullet security is analogous because, by definition, its WAL is equal to the time period until its maturity, since all of its principal cash flow occurs on its maturity date. For example, a mutual fund that limits its duration to that of a two-year Treasury note would be defined as having a WAL of two years, since a Treasury note with a period remaining to maturity of two years has a WAL of two years.

Five commenters insisted that short-term investment funds ("STIFs") and money market funds be treated equally for purposes of defining WAL because of their similarly low interest rate risk. Indeed, collective investment funds that adhere to STIF rules for national banks must have an average portfolio maturity of 90 days or less. 12 C.F.R. 9.18(b)(4)(ii)(B)(1)-(3). NCUA concurs in this recommendation.

For registered investment companies and collective investment funds, the final rule is revised to incorporate maximum WAL as disclosed in a prospectus or trust instrument. §702.105(a)(1). If not directly or indirectly disclosed there, however, the final rule retains the proposed WAL of greater than 5 years but less than or equal to 7 years. §702.105(a)(3). Treating STIFs and money market funds equally, the final rule classifies them as having a WAL of 1 year or less. §702.105(a)(2). To conform to these WAL classifications, the Call Report instructions will be revised to clearly classify mutual funds and collective investment funds by WAL.

(b) Callable fixed-rate debt obligations and deposits. As determined under the general WAL definition, the WAL of a callable fixed-rate debt obligation or deposit would be its actual maturity date. Five commenters addressed this result--two contending that the rule should take into consideration an option to redeem an investment prior to maturity; another urging use of "effective WAL" since the WAL of callable investments may change; and yet another preferring, without explanation, to rely on the WAL for callable "Agency" investments. One commenter criticized the use of WAL for callable investments as not appropriately recognizing the extent of risk.

Typical credit union investments in callable securities (such as "Agency" callable securities) are callable at the option of the issuer, not of the credit union. Investments in which credit unions hold an option to redeem prior to maturity typically would be characterized as "putable" investments,[12] rather than callable investments. Examination experience indicates credit unions rarely hold "putable" investment securities. In such rare instances, however, the general WAL definition would permit the WAL of "putable" securities to be computed on the basis of reasonable and supportable estimates of the times for principal cash flow.

To clarify reporting of debt obligations and deposit investments that are callable in whole at the option of the issuer, the final rule explicitly adopts the current Call Report practice of reporting such callable instruments with a WAL equal to the period remaining until the final maturity date, §702.105(b), instead of the period remaining until a call date. The final rule does not rely on WAL for the entire portfolio of callable instruments because such a dollar-weighted average measure would reduce the accuracy of the risk measure.

(c) Variable-rate debt obligations and deposits. Under the proposed rule, a variable-rate debt obligation or deposit would be categorized by its next rate adjustment period, rather than by its WAL. 65 FR at 8608. NCUA received no comments on this outcome. To clarify reporting of variable-rate investments, the final rule explicitly adopts the current Call Report practice of reporting variable-rate debt obligations and deposits in the WAL category corresponding to the period remaining to the next rate adjustment. §702.105(c).

(d) Capital in mixed-ownership Government corporations and corporate credit unions. The proposed WAL definition did not explicitly address the determination of WAL of stock in mixed-ownership Government corporations (e.g., Federal Home Loan banks and NCUA's Central Liquidity Facility) or capital in corporate credit unions. However, a commenter's inquiry about the WAL of Federal Home Loan bank stock that may be redeemed after a notice period led the NCUA Board to examine the WAL of

[12] An investment is "putable" if the owner of the investment (i.e., the holder) has the right, but not the obligation, to sell to the issuer at a given price (i.e., the strike price) on or during a specified time period (i.e., the exercise period). The issuer of a "putable" investment has the obligation to purchase the investment from the holder in the event the holder elects during the exercise period to sell to the issuer at the strike price. See Fabozzi at 11.

stock in mixed-ownership Government corporations, and member paid-in capital and membership capital in corporate credit unions. While such investments may have credit risk exposure, membership in such entities can provide credit unions with access to substantial sources of liquidity or funding. To better protect the NCUSIF from the risk of losses arising from liquidity events, NCUA encourages credit unions to join such entities that provide contingent liquidity.

To ensure that the WAL of investments in liquidity-enhancing entities does not excessively increase an RBNW requirement, thereby deterring such investments, the final rule explicitly specifies capital stock in mixed-ownership Government corporations, and member paid-in capital and membership capital in corporate credit unions, as having a WAL of greater than 1 year, but less than or equal to 3 years. §702.105(d).

(e) Investments in CUSOs. The proposed rule did not explicitly address investments in CUSOs. By properly structuring a CUSO, a credit union may limit its losses resulting from such operations to the amount of its investment in, and loans to, the CUSO. NCUA believes that the NCUSIF will be better protected from the risk of losses arising from service operations, and credit union members will be better served, if credit unions are not discouraged from forming and participating in CUSOs. In the absence of a CUSO, balance sheet assets used to support CUSO service operations would be treated as average risk assets and would be risk weighted as such. To ensure that CUSO investments are treated similarly, the final rule defines investments in CUSOs as having a WAL of greater than 1 year, but less than or equal to 3 years, §702.105(e), and subsequently weights them the same as average risk assets.

(f) Other equity securities. The final rule adds this provision to address equity securities (in which some federally-insured, State-chartered credit unions ("FISCUs") may be permitted to invest) for which a WAL is not explicitly defined elsewhere in §702.105, or cannot be determined because they do not have maturity dates (although certain preferred instruments may have conversion dates). Because there is no scheduled time for the return of principal, such securities have an infinite WAL. Accordingly, the final rule defines WAL for "other equity securities" as greater than 10 ten years, §702.105(f), corresponding to the final rule's maximum WAL category for investments. §702.106(c)(4).

7. Section 702.106 – Standard calculation of risk-based net worth requirement.

To implement the second step of the three-step process, called the "standard calculation," section 702.106 multiplies either the whole or different percentage tiers of each risk portfolio in section 702.104 by a corresponding risk weighting to yield a standard component. The sum of the eight standard components equals the RBNW requirement. See Table 3 in §702.106, and Appendix A. If a credit union's RBNW requirement under the standard calculation exceeds 6 percent, the credit union "is defined as 'complex' and [an RBNW] requirement is applicable." §702.103(a)(2). The

RBNW requirement is met when it is exceeded by a credit union's net worth ratio (generally, retained earnings as a percentage of total assets). The final rule retains the proposed components (formerly called "RBNW components"), modified as follows in section 702.106:

(a) Long-term real estate loans. The proposed standard component for "Long-term real estate loans" divided the contents of the corresponding risk portfolio into three percentage tiers of total assets--zero to 25 percent, weighted at 6 percent to represent average risk; 25 to 40 percent, weighted at 14 percent to protect against the higher marginal risk; and in excess of 40 percent, weighted at 16 percent to reflect corresponding increases in credit concentration risk and in the ratio of new loans to seasoned loans. 65 FR at 8609.

Twenty-five commenters sought to restructure the tiers and to reduce the corresponding weightings for each, but generally provided no justification for the adjustments. Five were content to apply the 14 percent weighting to the 25 to 40 percent tier, but objected that the 16 percent weighting applied to the tier in excess of 40 percent of total assets was excessive. Their rationale is that a credit union with a 40 percent concentration in long-term real estate loans does not necessarily have a greater percentage of new 30-year mortgages than a credit union with a 25 percent concentration. To acknowledge that credit union liabilities typically do not all reset overnight, NCUA agrees to reduce to 14 percent the proposed 16 percent weighting.

One commenter challenged as too conservative NCUA's reliance on a 300 basis point interest rate "shock test" to corroborate the assigned risk weightings. The 300 basis point shock test is a widely accepted measure of interest rate risk adopted for financial institution investment pre-purchase analysis by the Federal Financial Institutions Examination Council. FFIEC, "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities," 63 FR 20191, 20195 (April 23, 1998). For balance sheet-wide application, see Office of Thrift Supervision, "Thrift Bulletin 13a: Management of Interest Rate Risk, Investment Securities, and Derivative Activities," 63 FR 66351, 66361 (December 1, 1998). Therefore, the 300 basis point "shock test" is a legitimate basis for determining appropriate risk weightings.

In response to criticism of the 16 percent weighting, the final rule modifies the standard component for "Long-term real estate loans" by reducing it from three to two percentage tiers--up to and including 25 percent of total assets, weighted at 6 percent; and in excess of 25 percent of total assets, weighted at 14 percent. §702.106(a).

(b) Member business loans outstanding. The proposed standard component for "Member business loans outstanding" divided the contents of the corresponding risk portfolio by a single threshold of 12.25 percent of total assets. The tier below was weighted at 6 percent, and the tier in excess was weighted at 14 percent. 65 FR at 8609.

Asserting various justifications, fourteen commenters advocated reducing the proposed weightings to as low as 4 percent and reserving the 14 percent weighting only for MBLs in excess of 20 percent of total assets. Some compared losses for consumer loans against the losses for MBLs over an 8-year period and noted that actual losses for MBLs for that period were only 57 basis points, or 75 percent of the amount for consumer loans. Others pointed to the risk mitigating characteristics of MBLs with low loan-to-value ("LTV") ratios (e.g., 60 percent) which typically reprice within 3 to 5 years; and to short-term, seasonal loans secured by land, which are subject to greater regulation and higher reserving.

The commenters focused on credit risk exposure only, overlooking the interest rate risk and other relevant risks associated with MBLs. As the amount of MBLs outstanding increases, interest rate risk also typically increases, as does credit concentration risk. Accordingly, the final rule retains the proposed standard component without modification. §702.106(b).

(c) Investments**.** The proposed standard component for "Long-term investments" (since renamed simply "Investments") divided the contents of the corresponding risk portfolio by a single threshold of 15 percent of total assets. The tier below was weighted at 6 percent, and the tier in excess was weighted at 14 percent. 65 FR at 8609.

Although content with the 6 percent weighting, thirty-four commenters, generally without explanation, advocated increasing the threshold to a higher percentage of total assets. Two commenters suggested introducing an intermediate tier of 15 to 25 percent of total assets, weighted at 8 percent, with the excess over 25 percent weighted at no more than 10 percent.

Other commenters questioned NCUA's reliance on the 300 basis point interest rate "shock test" to develop risk weightings for investments. One commenter preferred using a gradual 1 or 2 percent rate "ramp," while another supported using a 200 basis point "shock test." Because the Call Report data does not provide mark-to-market valuation of all investments, the 300 basis point rate shock is appropriate to capture both current and potential mark-to-market loss. As explained above, it is widely accepted as a basis for financial institution investment pre-purchase analysis.

Finally, a commenter observed that the proposed 6 percent and 14 percent weightings for credit union investments exceed the weightings applied to investments under the credit-risk-weighted capital requirements applicable to banks under their system of PCA. See, e.g*.*, 12 C.F.R. 325.103. Indeed, the risk weightings proposed for credit unions are higher because the banks' credit-risk-weighted capital standards consider only credit risk, whereas CUMAA mandates that the RBNW requirement for credit unions take account of material risks, such as market risk, interest rate risk and other relevant risks. See §1790d(d)(2); S. Rep. at 13.

Consistent with the NCUA Board's determination to treat similar investments similarly in terms of risk, the final rule abandons the proposed 15 percent threshold in favor of uniform classification by WAL--a more refined measure of risk. To implement this fundamental modification, the final rule establishes the following four WAL buckets: 1 year or less; greater than 1 year, but less than or equal to 3 years; greater than 3 years, but less than or equal to 10 years; and greater than 10 years. The four WAL buckets are risk-weighted at 3, 6, 12 and 20 percent, respectively. §702.106(c). In the Call Report investment schedule, credit unions will now report their investments solely by WAL as specified in section 702.105.

In ascending order, the 3 percent weighting applied to the first WAL bucket, §702.106(c)(1), is the same weighting originally proposed for the "Low risk assets" risk portfolio, as explained in section C.5(d) above. The 6 percent weighting applied to the second bucket, §702.106(c)(2), is the same as that applied to the "Average risk assets" risk portfolio, §702.106(e), and reflects the inclusion of average risk investments in the "Investments" risk portfolio. The 12 percent weighting applied to the third bucket, §702.106(c)(3), mirrors the weighting that the "Investments" alternative component applies to the WAL bucket for greater than 5 years, but less than 7 years, §702.107(c)(4), and reflects an average level of risk across the three more refined buckets of that component having a WAL greater than 3 years, but less than 10 years. Finally, the 20 percent weighting for the fourth bucket, §702.106(c)(4), is based on the weighting that the "Investments" alternative component applies to investments with a WAL greater than 10 years. §702.107(c)(6).

(d) Low-risk assets. The proposed standard component for "Low risk assets" applied a risk weighting of 3 percent to the entire contents of the corresponding risk portfolio. 65 FR at 8609. As explained in section C.5(d) above, the "Low risk assets" risk portfolio has been modified to consist only of cash on hand and the NCUSIF deposit. §702.104(d). Because these assets carry virtually no risk, the final rule reduces to zero the risk weighting applied to the standard component for "Low risk assets." §702.106(d).

(e) Average-risk assets. The proposed standard component for "Average risk assets" applied a risk weighting of 6 percent to the entire contents of the corresponding risk portfolio. 65 FR at 8609. This weighting corresponds to the 6 percent net worth ratio required by CUMAA to be classified "adequately capitalized." §702.102(a)(2). No commenters addressed the risk weighting applied to this component; therefore, it is retained as proposed. §702.106(e).

(f) Loans sold with recourse. The proposed standard component for "Loans sold with recourse" applies a risk weighting of 6 percent to the entire contents of the corresponding risk portfolio, 65 FR at 8609, to account for retained credit risk and the operational risk of servicing such loans. The 6 percent weighting also parallels the minimum weighting required for on-balance sheet loans that have similar credit risk exposure. See, e.g., §702.106(a)(1) and (e). Two commenters advocated replacing the fixed 6 percent weighting for this component with a sliding scale of weights based on the loss experience of like assets as measured by, for example, the five-year loan loss ratio. At present, the limited number of credit unions that sell or swap loans with recourse does not justify the increased burden of reporting the data needed to analyze loss experience for this purpose. Accordingly, the final rule retains the fixed 6 percent risk weighting proposed for this component. §702.106(f).

(g) Unused member business loan commitments**.** The proposed standard component for "Unused member business loans" applied a risk weighting of 6 percent to the entire contents of the corresponding risk portfolio. 65 FR 8609. Eleven commenters invited NCUA to reduce the weighting for this component to between 3 and 4.5 percent, but generally gave no rationale. Others proposed inserting a threshold to divide the contents of the portfolio according to a minimum percentage of either assets, equity, or an historical rate at which MBL commitments convert to actual loans. The commenters would give the tier below that threshold a zero percent weighting. No empirical evidence was provided to support weighting different portions of the portfolio differently, much less to support weighting any portion of it at zero. Accordingly, the final rule retains the risk weighting for this standard component without modification. §702.106(g).

(h) Allowance**.** The proposed standard component for the "Allowance" risk portfolio applies a risk weighting of *negative* 100 percent to the entire contents of the corresponding risk portfolio (which itself is limited to the equivalent of 1.5 percent of total loans). §702.106(h). This effectively offsets the RBNW requirement otherwise resulting from the standard calculation, to reflect mitigation of risk through reserving for loan losses in the ALL. No commenters addressed the negative 100 percent risk weighting applied to this component to produce a credit against the RBNW requirement; therefore, it is retained as proposed. §702.106(h).

8. Section 702.107 -- Alternative components for standard calculation.

The third step of the three-step process gives a credit union the option to reduce the amount of its RBNW requirement under the standard calculation. To implement that step, section 702.107 (formerly section 702.106) multiplies the different remaining maturity or WAL buckets in each of three risk portfolios representing above average risk by a corresponding risk weighting to yield an "alternative component." See Table 4 in §702.107, and Appendix F. Compared to the standard components, the alternative components classify real estate loans, member business loans and investments in finer remaining maturity and WAL increments based on additional data provided by the credit union. Each alternative component that produces a smaller percentage than its corresponding standard component may then be substituted for its counterpart in section 702.106 to reduce the RBNW requirement originally determined under the standard calculation.

The sole commenter addressing the structure of section 702.107 insisted upon allowing all or none of the alternative components to be substituted for their counterpart standard components. NCUA disagrees, preferring to give credit unions maximum flexibility in meeting an RBNW requirement. Therefore, the final rule retains the proposed alternative components, modified as follows in section 702.107:

(a) Long-term real estate loans. The proposed alternative component for "Long-term real estate loans " divided the contents of the corresponding risk portfolio by remaining maturity buckets: greater than 3, but less than or equal to 5 years; greater than 5, but less than or equal to 12 years; greater than 12, but less than or equal to 20 years; and greater than 20 years. The four remaining maturity buckets were weighted at 6, 8, 12 and 16 percent, respectively. 65 FR at 8610-8611. The sum of the weighted buckets equals the "alternative component."

Seeking wholesale modification, one commenter condemned this alternative component as completely unnecessary, while another praised it as important in aiding credit unions to comply with PCA. Two commenters urged NCUA to require reporting of real estate loan balances by WAL instead of remaining maturity. Due to the inherent difficulty of relying on objective data in the Call Report to validate prepayment assumptions that affect the WAL of long-term real estate loans, NCUA considers remaining maturity to be the most reliable and least burdensome means of reporting real estate loans.

Ten other commenters generally sought to modify the maturity buckets and corresponding risk weightings. Two protested that the weightings were too harsh and should be adjusted downward to account for low LTV ratios. In contrast, a single commenter felt the weightings were too low. Two others indicated that the maturity ranges of the buckets were too broad, while another insisted there were too many buckets. Upon reconsideration, NCUA considers the maturity ranges of the buckets and all but one of the risk weightings to be reasonable based on examiner judgment of credit risk and interest rate risk in typical fixed-rate real estate loans.

The final rule modifies this alternative component in two respects. First, to parallel the 5-year maturity threshold adopted in the corresponding risk portfolio, §702.104(a), the 3-to-5 year remaining maturity bucket is deleted altogether from the "Long-term real estate loans" alternative component. Second, to parallel the 14 percent weighting adopted for loans above the 25 percent threshold in the corresponding standard component, §702.106(a)(2), the weighting applied in the alternative component to the remaining maturity bucket for loans in excess of 20 years is reduced from 16 to 14 percent. §702.107(a)(3); see Appendix C. The final rule otherwise retains the proposed alternative component without modification.

(b) Member business loans outstanding**.** The proposed alternative component for "Member business loans outstanding" categorized the contents of the corresponding risk portfolio first by fixed- versus variable-rate MBLs, and then by remaining maturity in five buckets for each category—3 years or less; greater than 3, but less than or equal to 5 years; greater than 5, but less than or equal to 7 years; greater than 7, but less than or equal to 12 years; and greater than 12 years.[13] 65 FR at

[13] For federally-chartered credit unions, the maturity of MBLs is limited to 12 years, except "lines of credit are not subject to a statutory or regulatory maturity limit." 12 C.F.R. 701.21(c)(4). This limit does

8610-8611. The five maturity buckets for fixed-rate MBLs were weighted at 6, 9, 12, 14 and 16 percent, respectively. The five maturity buckets for variable-rate MBLs were weighted at 6, 8, 10, 12 and 14 percent, respectively. The sum of the weighted buckets equals the “alternative component.”

Two commenters addressed this alternative component, suggesting structural modifications. The first argued that fixed-rate MBLs should be classified by WAL to take account of the interest rate premium, but that variable-rate MBLs should be weighted at a static 6 percent, regardless of WAL or remaining maturity, since it is unrealistic to require reserves equivalent to the decline in market value. The second commenter proposed weighting MBLs on a sliding scale to take account of the LTV ratios, e.g., 6 percent for an LTV ratio of less than 60 percent, and a 7 percent weighting for an LTV ratio between 60 and 70 percent.

NCUA declines to depart from the proposed rule for the following reasons.   First, as explained in the preceding section, due to the inherent difficulty of relying on objective Call Report data to validate prepayment assumptions, NCUA considers remaining maturity to be the most reliable and least burdensome means of reporting MBLs. Second, while the value of a variable-rate MBL may decline less in value than a similar fixed-rate MBL as a result of a given interest rate change, credit risk of a variable-rate MBL typically increases in a higher rate environment, as the borrower is forced to meet increased interest expense burden. Third, the proposed rule already recognized the inherent variation in risk between fixed-rate and variable-rate MBLs; in the 3-to-5 year remaining maturity bucket, the weighting applied to fixed-rate MBLs is 100 basis points higher than that applied to variable-rate MBLs; in the three buckets for remaining maturities greater than 5 years, the weighting applied to fixed-rate MBLs is 200 basis points higher than that applied to variable-rate MBLs. 65 FR at 8611 (Table 4.b.).

For these reasons, the final rule retains this alternative component without modification. §702.107(b) and Appendix D.

(c) Investments. The proposed alternative component for “Long-term investments” (here renamed simply “Investments”) classified the contents of the corresponding risk portfolio into four WAL buckets: greater than 3, but less than or equal to 5 years; greater than 5, but less than or equal to 7 years; greater than 7, but less than or equal to 10 years; and greater than 10 years. The four WAL buckets are weighted at 8, 12, 16 and 20 percent, respectively. 65 FR 8604. The sum of the weighted buckets yields the alternative component.

According to one commenter, NCUA did not select representative securities with sufficient interest rate risk, resulting in inadequate weightings. Although the

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not apply to MBLs and lines of credit issued by federally-insured, State-chartered credit unions. Thus, the alternative component for MBLs includes a bucket to accommodate MBLs and lines of credit “with a remaining maturity greater than 12 years.” §702.107(b)(1)(v) and (b)(2)(v).

representative securities reflect the shorter end of each WAL bucket, NCUA's research indicates that the proposed weighting applied to each WAL bucket approximates the economic value exposure. 65 FR at 8605. In addition, these securities implicitly acknowledge that credit union liabilities typically do not all reset overnight. As a result, the proposed weightings are adequate to protect the NCUSIF from material risk, and do not need to be increased.

Protesting that the proposed WAL buckets do not adequately recognize WAL differences within buckets, another commenter compared the U.S. Securities and Exchange Commission's ("SEC") use of smaller "haircuts" (i.e., percentage deductions) in computing net capital requirements for broker-dealers. 17 C.F.R. 240.15c3-1(c)(2)(vi). However, the SEC uses haircuts in what is generally a marked-to-market environment, and broker-dealers subject to its requirements are able to issue equity to increase net worth. In contrast, investments by credit unions generally are not marked-to-market. Even a credit union's gain or loss on "available-for-sale" securities is not reflected in net worth. See §702.2(f); 65 FR at 8565. Further, credit unions typically cannot issue equity instruments to increase net worth.

Principally to capture cash on deposit and cash equivalents (formerly within the "Low risk assets" risk portfolio) and other investments (formerly in the "Average risk assets" risk portfolio), the final rule modifies the alternative component for "Investments" by adding two buckets at the bottom of the WAL scale: one for investments having a WAL of one year or less, and another for investments with a WAL of greater than one year but less than or equal to 3 years. These buckets are weighted at 3 percent and 6 percent, respectively. §702.107(c)(1) and (2), and Appendix E. This alternative component is otherwise unchanged from the proposed rule.

9. Section 702.108 -- Risk mitigation credit to reduce risk-based net worth requirement.

Sixty-four commenters appealed to the NCUA Board to adopt a subjective or quantitative means for credit unions to demonstrate that the actual level of risk exposure to the NCUSIF is less than that indicated by the RBNW requirement resulting from the standard calculation, §702.106, or alternative components, §702.107.

To recognize mitigation of interest rate risk, forty-four commenters suggested considering the structure of funding liabilities and the results of "hedging" strategies. Commenters generally advocated flexibility toward sophisticated credit unions that implement internal modeling of an economic value exposure measure such as net economic value ("NEV"). A few commenters urged NCUA to consider a maturity gap, a "matched book," or an earnings exposure measure such as income simulation. For example, one commenter argued for an adjustment to the RBNW requirement in response to internal modeling that demonstrates limited interest rate risk through an NEV fluctuation calculation, with the calculation to be certified by NCUA. More subjectively, another commenter proposed an RBNW adjustment in consideration of a credit union's history, policies, practices, and risk management techniques.

To recognize mitigation of credit risk, fourteen commenters recommended considering the impact of such quantitative factors as low LTV ratio and private mortgage insurance. Ten advocated evaluating the quality of loan underwriting and standards.

Upon consideration of the comments, the NCUA Board is persuaded to permit credit unions to demonstrate interest rate risk mitigation through internal modeling of an economic value exposure measure such as NEV, and to demonstrate credit risk mitigation through quantitative indicators of below average credit risk in loan portfolios. To this end, the final rule introduces a "risk mitigation credit" ("RMC") to offset a credit union's applicable RBNW requirement.

Under section 702.108, a credit union which fails to meet its applicable RBNW requirement under both the standard calculation, §702.106, and the alternative components, §702.107, may apply to the NCUA Board for an RMC to reduce that requirement. The NCUA Board may, in its discretion, grant an RMC upon proof of mitigation of credit risk, or interest rate risk as demonstrated by economic value exposure measures. To ensure uniformity, an RMC request will be evaluated according to guidelines to be duly adopted by the NCUA Board. §702.108(a).

In the case of a FISCU seeking an RMC, the request must first be submitted to the appropriate State official (as defined in 12 C.F.R. 702.2(b) and appropriate Regional Director having jurisdiction over the FISCU. §702.108(b)(1). When evaluating a FISCU's request, the NCUA Board is required to "consult and seek to work cooperatively" with the appropriate State official and to provide prompt notice to him or her of its decision on the request. §702.108(b)(2).

The RMC is available only to credit unions which otherwise fail an RBNW requirement, because of the substantial commitment of NCUA resources required to administer the process of evaluating and deciding RMC applications. NCUA will be responsible for ensuring the validity and reliability of the quantitative measures used to demonstrate mitigation of risk through individual qualitative assessment of each applicant credit union. Under guidelines to be adopted before the effective date of the final rule, NCUA envisions a process for evaluating RMC applications which resembles the process used to consider requests for expanded authority by corporate credit unions under Appendix B to part 704, 12 C.F.R. 704.

D. GENERAL COMMENTS ON PROPOSED RULE

1. Regulatory capital. Numerous commenters reiterated the call for new forms of "regulatory capital" to play a role in PCA. NCUA may have the statutory authority to permit new sources of capital for federally-chartered credit unions. 12 U.S.C. 1757(7), 1757(9) (permitting NCUA to authorize regulatory capital in the form of

shares and subordinated debt). However, CUMAA's express, limited definition of net worth--retained earnings under GAAP--clearly precludes all but low income-designated credit unions from classifying such regulatory capital as net worth for PCA purposes. §1790d(o)(2). Nevertheless, NCUA recognizes that, if established, regulatory capital would be available to absorb losses, thereby insulating the NCUSIF from such losses. See §702.206(e) (criterion in evaluating net worth restoration plans). Depending on how it is structured, regulatory capital on the balance sheet of a credit union that meets the definition of "complex" could conceivably reduce the risk for which the RBNW requirement is designed to compensate. In the future, therefore, NCUA may consider proposals to amend part 702 to allow regulatory capital to offset an RBNW requirement. See, e.g., §702.106(h) ("Allowance" component).

2. Banking industry trade association comments. In its comment letter, a trade association of the banking industry made four principal comments on the proposed rule. First, that the final rule should exempt credit unions having assets of $10 million or less. This proposal to establish a minimum asset floor, made by many commenters, is adopted. Second, that a credit union should be deemed "complex" if it has either $50 million or more in assets, *any* MBLs in its asset portfolio, or *any* investments for which it is required to submit a quarterly monitoring report to NCUA. See 12 C.F.R. 703.70(a), 703.90(b). These three sweeping criteria, while simple, are overwhelmingly overinclusive; NCUA's objective is to develop an RBNW requirement that is tailored to a credit union's individual risk profile. Third, that CUMAA and the Treasury Department intended that NCUA model the RBNW requirement on the banks' risk-based capital framework. On the contrary, neither CUMAA nor the Treasury Department envisioned a clone of the banks' risk-based capital standards; rather, Congress instructed NCUA to develop a credit union-specific RBNW requirement, §1790d(i), which takes account of a full range of relevant risks. S. Rep. at 13. As explained in section C.7(d) above, the banks' approach addresses credit risk only. Third, that the proposed rule fails to take account of differences in credit quality among assets. The banks' risk-based capital standards create many broad categories of assets and do not further distinguish credit quality within a category. The final rule establishes fewer categories (i.e., risk portfolios, §702.104) and designates risk weightings to account for a broader range of risks (e.g., credit and interest rate risk). As explained in section C.4. above, NCUA's approach efficiently captures the risks to the NCUSIF that are the intended target of the RBNW requirement.

3. Recognition of unrealized gains and losses**.** Five commenters inquired about treatment of unrealized gains and losses on "available-for-sale" securities under SFAS 115. NCUA research indicated that failure to adjust net worth to reflect such gains and losses would rarely result in artificially misstating a credit union's net worth category classification. 65 FR at 8565. Thus, neither part 702 nor this final rule recognizes such gains and losses. NCUA reiterates that unrealized gains and losses are not reflected in net worth, the numerator of the net worth ratio, but do affect the denominator, total assets. §702.2(f).

4. "PCA Oversight Task Force." Ten commenters requested NCUA to

periodically review implementation of the final rule and to revise it as needed. Another commenter was concerned that NCUA would modify the final rule in response to changing economic conditions, without giving credit unions sufficient notice and opportunity to comply. In response to these concerns, the NCUA Board in February 2000 established a "PCA Oversight Task Force" and directed its members to review at least a full year of implementation of PCA and to recommend modifications in the Fall of 2001. Any such modifications (apart from RMC guidelines) will be made by formal rulemaking, including public notice and an opportunity to comment.

5. Method of calculating total assets. Several commenters inquired why a credit union is required to use its calendar quarter-end account balances to calculate an RBNW requirement, but may elect among four methods to calculate total assets in determining its net worth ratio. See §702.2(j). Similarly, another proposed calculating the RBNW requirement using average assets. The RBNW requirement must rely on quarter-end balances, rather than average balances, for consistency; because Call Report asset accounts are reported as of calendar quarter-end, the denominator for the eight "risk portfolios" also must be calendar quarter-end total assets. Otherwise, the sum of the balances in asset accounts (reported on a calendar quarter-end basis) would not necessarily equal the total assets (on other than a calendar quarter-end basis). To reconstruct the Call Report so that asset accounts are reported on an average basis does not appear to be cost justified for NCUA or for credit unions at this time.

E. IMPACT OF FINAL RULE

Under the proposed rule's four-trigger test, December 1999 Call Report data indicates that an estimated 1408 credit unions, or 13.2 percent of all credit unions, met the definition of "complex" and would be required to meet an RBNW requirement. Compare 65 FR at 8605 (6/99 data). As a result, an estimated twelve credit unions--representing 2.3 percent of credit unions defined as "complex" and .08 percent of all credit unions--would have failed their RBNW requirement under the proposed standard calculation.

By contrast, December 1999 Call Report data indicates the final rule's minimum asset "floor" would exempt 6195 credit unions having assets of $10 million or less. Of the remaining 4434 credit unions, 3982 would fall below the minimum 6 percent RBNW "floor." Thus, a total of 96 percent of all credit unions would be exempt from meeting an RBNW requirement at the outset.

The remaining 452 credit unions, by virtue of having an RBNW requirement in excess of 6 percent, would meet the definition of "complex" and be required to meet an "applicable risk-based net worth requirement." §702.103(a). Among these, the average RBNW requirement is estimated at 6.8 percent. Seventy-five percent of these credit unions have an RBNW requirement of 7.02 percent or less. For 90 percent of them, the RBNW requirement is 7.83 percent or less

In contrast, the average net worth ratio is an estimated 12.16 percent—more than 500 basis points higher than the average RBNW requirement. As a result, only an estimated 17 credit unions--representing 3.7 percent of the 452 credit unions meeting the definition of “complex,” and .0015 percent of all credit unions--would have failed their RBNW requirement under the standard calculation. §702.106. Some of these undoubtedly would meet that requirement by substituting alternative components, §702.107, or by obtaining an offsetting RMC. §702.108.

As Table 1 below indicates, as asset size increases toward $500 million, it becomes more likely that an RBNW requirement will be applicable.

TABLE 1 – ESTIMATED APPLICABILITY AND IMPACT OF RBNW REQUIREMENT[14]

Source: 12/99 data	A	B	C	D	E
Range of Total Assets for Credit Unions (CUs) > $10 Million (in $millions)	***Number of CUs >$10 Million***	***Number of CUs to which RBNW applies***	***Percentage of CUs to which RBNW applies /All CUs***	***Percentage of All CUs to which RBNW applies***	***Estimated Number Failing RBNW***
			B/A = C	**B/B total = D**	
Greater than $500	122	19	15.6%	4.2%	0
Greater than $100 to $500	698	137	19.6%	30.3%	5
Greater than $50 to $100	688	88	12.8%	19.5%	5
Greater than $20 to $50	1,473	133	9.0%	29.4%	5
Greater than $15 to $20	572	34	5.9%	7.5%	0
Greater than $10 to $15	881	41	4.7%	9.1%	2
Total	4,434	452	10.2%		17

The estimates in Table 1 above are based on December 1999 Call Report data as indicated in Table 2 below. The line item references are subject to change when the Call Report is revised to conform with part 702 and to incorporate the "PCA Worksheet."

14 NCUA has relied on estimates to assess the impact of certain modifications to the final rule because the present Call Report does not collect the necessary data in sufficient detail. As a result, the use of Call Report data has the following impact: (1) the "Long-term real estate loans" risk portfolio includes loans with a remaining maturity between 3 to 5 years, resulting in an overestimate of the RBNW requirement under the standard calculation, §702.104(a); (2) the "Investments" risk portfolio includes mutual funds in the WAL bucket of one year or less, resulting in an underestimate of the RBNW requirement under the standard calculation, §§702.104(c), 702.105(a)(1); (3) the "Low risk assets" risk portfolio includes cash on deposit and cash equivalents, resulting in an underestimate of the RBNW requirement under the standard calculation, §702.104(d); and (4) the "Unused member business loan commitments" risk portfolio includes only unused commitments for commercial real estate construction and land development, resulting in an underestimate of the RBNW requirement under the standard calculation. §702.104(g).

TABLE 2 – PRESENT CALL REPORT LINE ITEMS FOR ESTIMATING RBNW REQUIREMENT

Risk Portfolio	*Call Report Items Used to Estimate Risk Portfolios*	*Call Report Estimate*
(a) Long-term real estate loans	Total real estate loans **less**: i. The amount of real estate loans that meet the definition of a member business loan. ii. Real estate loans that will contractually refinance, reprice or mature within 3 years.	Schedule A, line 3 (Acct. codes 710) **less**: i. Schedule A, line 9 (Acct. code 718) ii. Schedule A, line 11 (Acct. code 712)
(b) Member business loans	Outstanding member business loans	Schedule B, line 3 (Acct. code 400)
(c) Investments	All credit union investments categorized by weighted-average life or repricing interval: i. Less than 1 Year ii. 1-3 Years iii. 3-10 Years iv. Greater than 10 Years	Schedule C: i. Line 12 (Acct. code 799A) ii. Line 12 (Acct. code 799B) iii. Line 12 (Acct code 799C) iv. Line 12 (Acct code 799D)
(d) Low-risk Assets	i. Cash and cash equivalents ii. NCUSIF Deposit	i. Assets, line 1 (Acct. code 730) ii. Assets line 25 (Acct code 794)
(e) Average-risk Assets	Total Assets **less:** Risk Portfolios (a) through (d).	Assets, line 27 (Acct. code 010) **less**: Risk Portfolio line items (a) through (d) above.
(f) Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse	Schedule G, line 2.B. (Acct. code 819)
(g) Unused MBL Commitments	Commercial real estate construction and land development	Schedule G, line 1.D. (Acct. code 814)
(h) Allowance	Allowance for Loan and Lease Losses	Assets, line 21 (Acct. code 719) (Limited to equivalent of 1.5 percent of total loans.)

Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis describing any significant economic impact a final regulation may have on a substantial number of small credit unions (primarily those under $1 million in assets). The final rule establishes an RBNW requirement to apply to federally-insured credit unions which meet the definition of "complex." The RBNW requirement is expressly mandated by CUMAA as a component of NCUA's system of prompt corrective action. §1790d(d).

For the purpose of this analysis, credit unions under $1 million in assets will be considered small entities. As of June 30, 1999, there were 1,690 such entities with a total of $807.3 million in assets, with an average asset size of $0.5 million. These small entities make up 15.6 percent of all credit unions, but only 0.2 percent of all credit union assets.

The proposed rule implements a three-step process involving eight "risk portfolios." The first step is to determine whether a credit union meets the definition of “complex” and an RBNW requirement is applicable, based on a minimum asset size of $10 million and minimum RBNW requirement of 6 percent. The second step uses eight standard components (which multiply the “risk portfolios” by corresponding risk weightings) to determine the applicable RBNW requirement. The third step provides a credit union the opportunity to substitute any of three specific standard components with a corresponding alternative component that may reduce the RBNW requirement against which the credit union’s quarterly net worth ratio is measured. Credit unions that do not meet an applicable RBNW requirement under both the standard calculation and the alternative components may apply for a risk mitigation credit to reduce that requirement to reflect mitigation of credit risk or interest rate risk.

The NCUA Board does not believe that the final rule would impose reporting or recordkeeping burdens that require specialized professional skills not available to small entities. Further, NCUA estimates that, due the $10 million asset minimum, none of these small entities will be subject to an applicable RBNW requirement under the additional requirements of the final rule. There are no other relevant federal rules that duplicate, overlap, or conflict with the final rule.

Paperwork Reduction Act

The reporting requirements in this rule have been submitted to the Office of Management and Budget. Under the Paperwork Reduction Act of 1995, no person is required to respond to a collection of information unless it displays a valid OMB number. Control number 3133-0161 has been issued and will be displayed in the table at 12 C.F.R. part 795.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily adheres to the fundamental federalism principles addressed by the executive order. This final rule will apply to all federally-insured credit unions, including federally-insured, State-chartered credit unions. Accordingly, it may have a direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. This impact is an unavoidable consequence of carrying out the statutory mandate to adopt a system of prompt corrective action to apply to all federally-insured credit unions. Throughout the rulemaking process, NCUA staff has consulted with a committee of representative state regulators regarding the impact of the RBNW requirement on state-chartered credit unions. The committee’s comments and suggestions are reflected in the final rule.

Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104-121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by section 551 of the Administrative Procedure Act, 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule.

List of Subjects

12 CFR Part 700

Credit unions.

12 CFR Part 702

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on July 13, 2000.

Becky Baker
Secretary of the Board

Accordingly, 12 C.F.R. parts 700 and 702 are amended as set forth below:

PART 700 DEFINITIONS

1. The authority citation for part 700 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1757(6) and 1766

2. Section 700.1 is amended by removing paragraph (i) and redesignating paragraphs (j) and (k) as paragraphs (i) and (j), respectively.

PART 702 PROMPT CORRECTIVE ACTION

3. The authority citation for part 702 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1790d.

4. Section 702.2 is amended in paragraph (j)(2) by removing “702.106” and adding “702.108” in its place; and by adding paragraph (k) to read as follows:

§702.2 Definitions

* * * * *

(k) Weighted-average life means the weighted-average time to the return of a dollar of principal, calculated by multiplying each portion of principal received by the time at which it is expected to be received (based on a reasonable and supportable estimate of that time), and then summing and dividing by the total amount of principal.

5. Section 702.102 is amended in paragraphs (a)(1), (a)(2) and (a)(3) by removing the phrase “702.105 and 702.106” and by adding “702.103 through 702.108” in its place.

6. Sections 702.103, 702.104, 702.105, 702.106, 702.107 and 702.108 are added to Subpart A of part 702 to read as follows:

§702.103 Applicability of risk-based net worth requirement.

(a) Criteria. For purposes of §702.102, a credit union is defined as “complex” and a risk-based net worth requirement is applicable only if the credit union meets both of the following criteria as reflected its most recent Call Report:

(1) Minimum asset size. Its quarter-end total assets exceed ten million dollars ($10,000,000); and

(2) Minimum RBNW calculation. Its risk-based net worth requirement as calculated under §702.106 exceeds six percent (6%).

(b) Optional Call Report filing. For purposes of this part, a credit union which is required to file a Call Report only semiannually may elect to file a Call Report for the first and/or third quarter of a calendar year.

§702.104 Risk portfolios defined.

A risk portfolio is a portfolio of assets, liabilities, or contingent liabilities as specified below, each expressed as a percentage of the credit union's quarter-end total assets reflected in its most recent Call Report, rounded to two decimal places (Table 1):

(a) Long-term real estate loans. Total real estate loans and real estate lines of credit outstanding, exclusive of those outstanding that will contractually refinance, reprice or mature within the next five (5) years, and exclusive of all member business loans (as defined in 12 C.F.R. 723.1 or as approved under 12 C.F.R. 723.20);

(b) Member business loans outstanding. All member business loans as defined in 12 C.F.R. 723.1 or as approved under 12 C.F.R. 723.20;

(c) Investments. Investments as defined by 12 C.F.R. 703.150 or applicable State law, including investments in CUSOs (as defined by §702.2(d));

(d) Low-risk assets. Cash on hand (e.g., coin and currency, including vault, ATM and teller cash) and the NCUSIF deposit;

(e) Average-risk assets. One hundred percent (100%) of total assets minus the sum of the risk portfolios in paragraphs (a) through (d) of this section;

(f) Loans sold with recourse. Outstanding balance of loans sold or swapped with recourse, excluding loans sold to the secondary mortgage market that have representations and warranties consistent with those customarily required by the U.S. Government and government sponsored enterprises;

(g) Unused member business loan commitments. Unused commitments for member business loans as defined in 12 C.F.R. 723.1 or as approved under 12 C.F.R. 723.20; and

(h) Allowance. The Allowance for Loan and Lease Losses not to exceed the equivalent of one and one-half percent (1.5%) of total loans outstanding.

TABLE 1 -- §702.104 RISK PORTFOLIOS DEFINED

Risk portfolio	*Assets, liabilities or contingent liabilities*
(a) Long-term real estate loans	Total real estate loans and real estate lines of credit (excluding MBLs) with a maturity (and next rate adjustment period if variable rate) greater than 5 years
(b) MBLs outstanding	Member business loans outstanding
(c) Investments	As defined by federal regulation or applicable State law.
(d) Low-risk assets	Cash on hand and NCUSIF deposit.
(e) Average-risk assets	100% of total assets minus sum of risk portfolios above
(f) Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less.
(g) Unused MBL commitments	Unused commitments for MBLs
(h) Allowance	Allowance for Loan and Lease Losses limited to equivalent of 1.50 percent of total loans

§702.105 Weighted-average life of investments.

Except as provided below (Table 2), the weighted-average life of an investment for purposes of §§702.106(c) and 702.107(c) is defined pursuant to §702.2(k):

(a) Registered investment companies and collective investment funds.

(1) For investments in registered investment companies (e.g., mutual funds) and collective investment funds, the weighted-average life is defined as the maximum weighted-average life disclosed, directly or indirectly, in the prospectus or trust instrument;

(2) For investments in money market funds, as defined in 17 C.F.R. 270.2a-7, and collective investment funds operated in accordance with short-term investment fund rules set forth in 12 C.F.R. 9.18(b)(4)(ii)(B)(*1*)-(*3*), the weighted-average life is defined as one (1) year or less; and

(3) For other investments in registered investment companies or collective investment funds, the weighted-average life is defined as greater than five (5) years, but less than or equal to seven (7) years;

(b) Callable fixed-rate debt obligations and deposits. For fixed-rate debt obligations and deposits that are callable in whole, the weighted-average life is defined as the period remaining to the maturity date;

(c) Variable-rate debt obligations and deposits. For variable-rate debt obligations and deposits, the weighted-average life is defined as the period remaining to the next rate adjustment date;

(d) Capital in mixed-ownership Government corporations and corporate credit unions. For capital stock in mixed-ownership Government corporations, as defined in 31 U.S.C. 9101(2), and member paid-in capital and membership capital in corporate credit unions, as defined in 12 C.F.R. 704.2, the weighted-average life is defined as greater than one (1) year, but less than or equal to three (3) years;

(e) Investments in CUSOs. For investments in CUSOs (as defined in §702.2(d)), the weighted-average life is defined as greater than one (1) year, but less than or equal to three (3) years; and

(f) Other equity securities. For other equity securities, the weighted average life is defined as greater than ten (10) years.

TABLE 2 -- §702.105 WEIGHTED-AVERAGE LIFE OF INVESTMENTS

Investment	*Weighted-average life*
(a) Registered investment companies and collective investment funds	i. *Registered investment companies and collective investment funds*: As disclosed in prospectus or trust instrument, but if not disclosed, greater than five (5) years, but less than or equal to seven (7) years. ii. *Money market funds and STIFs*: One (1) year or less.
(b) Callable fixed-rate debt obligations and deposits	Period remaining to maturity date.
(c) Variable-rate debt obligations and deposits	Period remaining to next rate adjustment date.
(d) Capital in mixed-ownership Government corporations and corporate credit unions	Greater than one (1) year, but less than or equal to three (3) years.
(e) Investments in CUSOs	Greater than one (1) year, but less than or equal to three (3) years.
(f) Other equity securities	Greater than ten (10) years.

§702.106 Standard calculation of risk-based net worth requirement.

A credit union's risk-based net worth requirement is the aggregate of the following standard component amounts, each expressed as a percentage of the credit union's quarter-end total assets as reflected in its most recent Call Report, rounded to two decimal places (Table 3):

(a) Long-term real estate loans. The sum of:

(1) Six percent (6%) of the amount of long-term real estate loans less than or equal to twenty-five percent (25%) of total assets; and

(2) Fourteen percent (14%) of the amount in excess of twenty-five percent (25%) of total assets;

(b) Member business loans outstanding. The sum of:

(1) Six percent (6%) of the amount of member business loans outstanding less than or equal to twelve and one-quarter percent (12.25%) of total assets; and

(2) Fourteen percent (14%) of the amount in excess of twelve and one-quarter percent (12.25%) of total assets;

(c) Investments. The sum of:

(1) Three percent (3%) of the amount of investments with a weighted-average life (as specified in §702.105 above) of one (1) year or less;

(2) Six percent (6%) of the amount of investments with a weighted-average life greater than one (1) year, but less than or equal to three (3) years;

(3) Twelve percent (12%) of the amount of investments with a weighted-average life greater than three (3) years, but less than or equal to ten (10) years; and

(4) Twenty percent (20%) of the amount of investments with a weighted-average life greater than ten (10) years;

(d) Low-risk assets. Zero percent (0%) of the entire portfolio of low-risk assets;

(e) Average-risk assets. Six percent (6%) of the entire portfolio of average-risk assets;

(f) Loans sold with recourse. Six percent (6%) of the entire portfolio of loans sold with recourse;

(g) Unused member business loan commitments. Six percent (6%) of the entire portfolio of unused member business loan commitments; and

(h) Allowance. Negative one hundred percent (-100%) of the balance of the Allowance for Loan and Lease Losses account, not to exceed the equivalent of one and one-half percent (1.5%) of total loans outstanding.

TABLE 3 -- §702.106 STANDARD CALCULATION OF RBNW REQUIREMENT

Risk portfolio	*Amount of risk portfolio (as percent of quarter-end total assets) to be multiplied by risk weighting*	*Risk weighting*
(a) Long-term real estate loans	0 to 25.00% over 25.00%	.06 .14
(b) MBLs outstanding	0 to 12.25% over 12.25%	.06 .14
(c) Investments	*By weighted-average life*: 0 to 1 year >1year to 3 years >3 years to 10 years >10 years	.03 .06 .12 .20
(d) Low-risk assets	All %	.00
(e) Average-risk assets	All %	.06
(f) Loans sold with recourse	All %	.06
(g) Unused MBL commitments	All %	.06
(h) Allowance	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets)	(1.00)
A credit union's RBNW requirement is the sum of eight standard components. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk weighting. A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.		

§702.107 Alternative components for standard calculation.

A credit union may substitute one or more alternative components below, in place of the corresponding standard components in §702.106 above, when any alternative component amount, expressed as a percentage of the credit union's quarter-end total assets as reflected in its most recent Call Report, rounded to two decimal places, is smaller (Table 4):

(a) Long-term real estate loans. The sum of:

(1) Eight percent (8%) of the amount of such loans with a remaining maturity of greater than 5 years, but less than or equal to 12 years;

(2) Twelve percent (12%) of the amount of such loans with a remaining maturity of greater than 12 years, but less than or equal to 20 years; and

(3) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 20 years;

(b) Member business loans outstanding. The sum of:

(1) Fixed rate. Fixed-rate member business loans outstanding as follows:

(i) Six percent (6%) of the amount of such loans with a remaining maturity of 3 or fewer years;

(ii) Nine percent (9%) of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;

(iii) Twelve percent (12%) of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;

(iv) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and

(v) Sixteen percent (16%) of the amount of such loans with a remaining maturity greater than 12 years; and

(2) Variable-rate. Variable-rate member business loans outstanding as follows:

(i) Six percent (6%) of the amount of such loans with a remaining maturity of 3 or fewer years;

(ii) Eight percent (8%) of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;

(iii) Ten percent (10%) of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;

(iv) Twelve percent (12%) of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and

(v) Fourteen percent (14%) of the amount of such loans with a remaining maturity greater than 12 years.

(c) Investments. The sum of:

(1) Three percent (3%) of the amount of investments with a weighted-average life (as specified in §702.105 above) of one (1) year or less;

(2) Six percent (6%) of the amount of investments with a weighted-average life greater than one (1) year, but less than or equal to three (3) years;

(3) Eight percent (8%) of the amount of investments with a weighted-average life greater than three (3) years, but less than or equal to five (5) years;

(4) Twelve percent (12%) of the amount of investments with a weighted-average life greater than five (5) years, but less than or equal to seven (7) years;

(5) Sixteen percent (16%) of the amount of investments with a weighted-average life greater than seven (7) years, but less than or equal to ten (10) years; and

(6) Twenty percent (20%) of the amount of investments with a weighted-average life greater than ten (10) years.

TABLE 4 -- §702.107 ALTERNATIVE COMPONENTS FOR STANDARD CALCULATION

(a) LONG-TERM REAL ESTATE LOANS

Amount of long-term real estate loans by remaining maturity	*Alternative risk weighting*
> 5 years to 12 years	.08
> 12 years to 20 years	.12
> 20 years	.14

The "alternative component" is the sum of each amount of the Long-term real estate loans risk portfolio by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.

(b) MEMBER BUSINESS LOANS

Amount of member business loans by remaining maturity	*Alternative risk weighting*
Fixed-rate MBLs 0 to 3 years	.06
> 3 years to 5 years	.09
> 5 years to 7 years	.12
> 7 years to 12 years	.14
> 12 years	.16
Variable-rate MBLs 0 to 3 years	.06
> 3 years to 5 years	.08
> 5 years to 7 years	.10
> 7 years to 12 years	.12
> 12 years	.14

The "alternative component" is the sum of each amount of the member business loans risk portfolio by fixed and variable rate and by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.

(c) INVESTMENTS

Amount of investments by weighted-average life	*Alternative risk weighting*
0 to 1 year	.03
>1 year to 3 years	.06
>3 years to 5 years	.08
>5 years to 7 years	.12
>7 years to 10 years	.16
> 10 years	.20

The "alternative component" is the sum of each amount of the Investments risk portfolio by weighted-average life (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.

§702.108 Risk mitigation credit to reduce risk-based net worth requirement.

(a) Application for credit. Upon application by a credit union which fails to meet its applicable risk-based net worth requirement, and pursuant to guidelines duly adopted by the NCUA Board, the NCUA Board may in its discretion grant a credit to reduce a risk-based net worth requirement under sections 702.106 and 702.107 upon proof of mitigation of:

(1) Credit risk; or

(2) Interest rate risk as demonstrated by economic value exposure measures.

(b) Application by FISCU. In the case of a FISCU seeking a risk mitigation credit—

(1) Before an application under paragraph (a) above may be submitted to the NCUA Board, it must be submitted in duplicate to the appropriate State official and the appropriate Regional Director; and

(2) The NCUA Board, when evaluating the application of a FISCU, shall consult and seek to work cooperatively with the appropriate State official, and shall provide prompt notice of its decision to the appropriate State official.

7. Appendices A through F are added to subpart A to read as follows:

APPENDICES TO SUBPART A

APPENDIX A – EXAMPLE STANDARD COMPONENTS FOR RBNW REQUIREMENT, §702.106 (EXAMPLE CALCULATION IN BOLD)

Risk portfolio	***Dollar balance***	***Amount as percent of quarter-end total assets***	*Risk weighting*	***Amount times risk weighting***	***Standard component***
Quarter-end total assets	**200,000,000**	**100.0000 %**			
(a) Long-term real estate loans	**60,000,000**	**30.0000 % =**			**2.20 %**
Threshold amount: 0 to 25%		**25.0000 %**	.06	**1.5000 %**	
Excess amount: over 25%		**5.0000 %**	.14	**0.7000 %**	
(b) MBLs outstanding	**25,000,000**	**12.5000 % =**			**0.77 %**
Threshold amount: 0 to 12.25%		**12.2500 %**	.06	**0.7350 %**	
Excess amount: over 12.25%		**0.2500 %**	.14	**0.0350 %**	
(c) Investments	**50,000,000 =**	**25.0000 % =**			**1.51 %**
Weighted-average life:					
0 to 1 year	**24,000,000**	**12.0000 %**	.03	**0.3600 %**	
>1 year to 3 years	**15,000,000**	**7.5000 %**	.06	**0.4500 %**	
>3 years to 10 years	**10,000,000**	**5.0000 %**	.12	**0.6000 %**	
>10 years	**1,000,000**	**0.5000 %**	.20	**0.1000 %**	
(d) Low-risk assets	**4,000,000**	**2.0000 %**	.00		**0 %**
Sum of risk portfolios (a) through (d) above	**139,000,000**	**69.5000 %**			
(e) Average-risk assets	**61,000,000**	**30.5000 %**[a]	.06		**1.83 %**
(f) Loans sold with recourse	**40,000,000**	**20.0000 %**	.06		**1.20 %**
(g) Unused MBL commitments	**5,000,000**	**2.5000 %**	.06		**0.15 %**
(h) Allowance	**2,040,000.00** [b]	**1.0200 %**	(1.00)		**(1.02) %**
Sum of standard components: **RBNW requirement** [c]					**6.64 %**

[a] The Average-risk assets risk portfolio percent of quarter-end total assets equals 100 percent minus the sum of the percentages in the four risk portfolios above (i.e., Long-term real estate loans, MBLs outstanding, Investments, and Low-risk assets).
[b] The Allowance risk portfolio is limited to the equivalent of 1.50 percent of total loans. For an example computation of the permitted dollar balance of Allowance, see worksheet in Appendix B below.
[c] A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement. The dollar equivalent of RBNW requirement may be computed for informational purposes as the RBNW requirement percent of total assets.

APPENDIX B – ALLOWANCE RISK PORTFOLIO DOLLAR BALANCE WORKSHEET
(EXAMPLE CALCULATION IN BOLD)

Balance sheet account	***Dollar balance***	***Percent of total loans***	*Range of ALL permitted*	***Permitted ALL percent of total loans***	***Permitted dollar balance of Allowance***
Allowance for Loan and Lease Losses (ALL)	**2,400,000**	**1.7647%**	0 to 1.50%	**1.50%**	**2,040,000**
Total loans	**136,000,000**				

APPENDIX C – EXAMPLE LONG-TERM REAL ESTATE LOANS ALTERNATIVE COMPONENT, §702.107(a)
(EXAMPLE CALCULATION IN BOLD)

Remaining maturity	***Dollar balance of Long-term real estate loans by remaining maturity***	***Percent of total assets by remaining maturity***	*Alternative risk weighting*	***Alternative component***
> 5 years to 12 years	**40,000,000**	**20.0000 %**	.08	**1.6000 %**
> 12 years to 20 years	**15,000,000**	**7.5000 %**	.12	**0.9000 %**
> 20 years	**5,000,000**	**2.5000 %**	.14	**0.3500 %**
Sum of above equals Alternative component*				**2.85 %**

* Substitute for standard component if lower.

APPENDIX D – EXAMPLE OF MEMBER BUSINESS LOANS ALTERNATIVE COMPONENT, §702.107(b)
(EXAMPLE CALCULATION IN BOLD)

Remaining maturity	***Dollar balance of MBLs by remaining maturity***	***Percent of total assets by remaining maturity***	*Alternative risk weighting*	***Alternative component***
Fixed-rate MBLs 0 to 3 years	**6,000,000**	**3.0000 %**	.06	**0.1800 %**
> 3 years to 5 years	**4,000,000**	**2.0000 %**	.09	**0.1800 %**
> 5 years to 7 years	**2,000,000**	**1.0000 %**	.12	**0.1200 %**
> 7 years to 12 years	**0**	**0.0000 %**	.14	**0.0000 %**
> 12 years	**0**	**0.0000 %**	.16	**0.0000 %**
Variable-rate MBLs 0 to 3 years	**7,000,000**	**3.5000 %**	.06	**0.2100 %**
> 3 years to 5 years	**4,000,000**	**2.0000 %**	.08	**0.1600 %**
> 5 years to 7 years	**2,000,000**	**1.0000 %**	.10	**0.1000 %**
> 7 years to 12 years	**0**	**0.0000 %**	.12	**0.0000 %**
>12 years	**0**	**0.0000 %**	.14	**0.0000 %**
Sum of above equals Alternative component*				**0.95 %**

* Substitute for standard component if lower.

Appendix E -- Example of Investments Alternative Component, §702.107(c)
(Example calculation in bold)

Weighted-average life	***Dollar balance of investments by weighted-average life***	***Percent of total assets by weighted-average life***	*Alternative risk weighting*	***Alternative component***
0 to 1 year	**24,000,000**	**12.0000 %**	.03	**0.3600 %**
> 1 year to 3 years	**15,000,000**	**7.5000 %**	.06	**0.4500 %**
> 3 years to 5 years	**8,000,000**	**4.0000 %**	.08	**0.3200 %**
> 5 years to 7 years	**1,000,000**	**0.5000 %**	.12	**0.0600 %**
> 7 years to 10 years	**1,000,000**	**0.5000 %**	.16	**0.0800 %**
> 10 years	**1,000,000**	**0.5000 %**	.20	**0.1000 %**
Sum of above equals Alternative component*				**1.37 %**

* Substitute for standard component if lower.

Appendix F -- Example RBNW requirement using Alternative Components
(Example calculation in bold)

Risk portfolio	***Standard component***	***Alternative component***	***Lower of standard or alternative component***
(a) Long-term real estate loans	**2.20 %**	**2.85 %**	**2.20 %**
(b) MBLs outstanding	**0.77 %**	**0.95 %**	**0.77 %**
(c) Investments	**1.51 %**	**1.37 %**	**1.37 %**
			Standard component
(d) Low-risk assets			**0 %**
(e) Average-risk assets			**1.83 %**
(f) Loans sold with recourse			**1.20 %**
(g) Unused MBL commitments			**0.15 %**
(h) Allowance			**(1.02) %**
RBNW requirement* Compare to Net Worth Ratio			**6.50 %**

* A credit union is “undercapitalized” if its net worth ratio is less than its applicable RBNW requirement.

8. Section 702.302 is amended by removing the phrase “and any risk based net worth requirement applicable to a new credit union defined as ‘complex’ under §§702.103 through 702.106” from paragraph (a); and by removing the phrase “and also meets any applicable risk-based net worth requirement under §§702.105 and 702.106” from paragraphs (c)(1), (c)(2) and (c)(3).